



Economic and Social Council

Distr.: General
20 April 2018

Original: English

2018 session

27 July 2017–26 July 2018

Agenda item 15

Regional cooperation

Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2017–2018

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith a report on the economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States) for the period 2017–2018.



Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2017–2018

Summary

The present report presents the economic performance in the countries of the Economic Commission for Europe region in 2017 and early 2018 and future prospects. The pace of economic expansion accelerated in 2017 amid supportive global and policy conditions. All countries registered positive growth for the first time since the global financial crisis, though there were significant differences in subregional and country performance. The normalization of monetary policy is advancing at different speeds in the United States of America and in the euro area, owing to the disparity in their respective cyclical positions. In contrast, further loosening of monetary policy was generally observed in the Commonwealth for Independent States, amid still-falling inflation. The recovery has become more synchronized and the outlook remains positive; however, significant risks remain.

I. Introduction

1. The Economic Commission for Europe (ECE) region includes 56 member States with very different development levels and economic situations. It contains most of the world's advanced countries but also a number of lower-middle-income economies. For analytical purposes, the present report will divide this large and diverse number of countries into different subregions and group them into two major categories: advanced economies and emerging economies. Advanced economies include North America, composed of Canada and the United States of America; the countries that are part of the euro area; and other advanced European economies. European emerging economies include new European Union member States that have not yet joined the euro area; non-European Union countries in South-Eastern Europe, including Turkey; and countries belonging to the Commonwealth of Independent States and Georgia.

II. Overview

2. The pace of economic activity accelerated in the member States of the Economic Commission for Europe in 2017. For the first time since the 2008 global financial crisis, positive growth was observed in all countries of the region, though there were marked differences in subregional and country performance. The growth of aggregate output increased from 1.7 per cent in 2016 to 2.6 per cent in 2017. That expansion has taken place in the context of a stronger global economy in which past concerns on stagnation are being put aside.

3. Throughout the region, increased signs of economic dynamism have emerged, including rising investment and growth in productivity. Deflation is no longer a threat in advanced countries and the focus is now on how quickly inflationary pressures might develop and how fast the normalization of monetary policy will proceed. So far those pressures have remained muted, which has resulted in countries favouring a gradual tightening of monetary policies. Divergence in monetary policy between the United States, where the recovery has been more sustained, and the euro area has increased. Public finances in the euro area have improved and fiscal policy is no longer restrictive, but fiscal plans for expansion in the United States will result in increased differences in that area as well, and may have potential implications for future monetary policy paths. In contrast, the economic outlook in most countries of the Commonwealth of Independent States, where inflation continued to fall in 2017 and growth prospects were moderate, prompted further loosening of monetary policy. In addition, energy-exporting countries have been adapting their fiscal frameworks to persistently low oil prices.

4. While the economic outlook in the region is generally positive, there are significant risks and sources of uncertainty. After a long period of lax financial conditions, the normalization of monetary policy may reveal hidden frailties. In some countries in the region, low interest rates have fuelled very rapid price increases in housing. In others, large external financing needs are a source of vulnerability that might be exacerbated by increases in interest rates. Geopolitical tensions persist and the prospect of trade conflicts has emerged, which may damage confidence and investment and lead to potentially large negative spillover effects.

5. Nevertheless, the improved economic situation creates a more auspicious context in which to tackle structural challenges while advancing the 2030 Agenda for Sustainable Development and ensuring that this increased economic dynamism is accompanied by progress towards more inclusive and environmentally sustainable economies.

III. North America

6. The uninterrupted expansion of the economy in the United States for almost a decade has made its recovery one of the longest on record. Gross domestic product (GDP) growth accelerated in 2017, rising by 2.3 per cent, up from 1.5 per cent in 2016. Overall, output is 15 per cent above pre-crisis levels.

7. Falling unemployment and rising asset prices boosted consumption. The personal savings rate declined further, reaching levels not seen since before the global financial crisis. By December 2017, it had dropped to 2.4 per cent, the lowest since September 2005. However, the most significant contribution to the acceleration of GDP was provided by increased investment amid improved confidence. Residential investment, however, trailed behind overall investment. Increased exports, which benefited from a weaker United States dollar and the recovery of the global economy, added to the momentum, but the contribution of net external demand to growth remained slightly negative. Tax policy changes are expected to lend further impetus to economic activity in 2018. Fiscal policy is projected to become more expansionary, with investment reacting positively to cuts in corporate income tax.

8. Unemployment, which was at 4.1 per cent as of February 2018, has fallen to levels below those observed prior to the global financial crisis. Broad measures of unemployment, which include marginally attached and part-time workers, have also continued to improve. The dynamics of the labour market in early 2018 indicated continued strong momentum for job creation. The continued expansion has had a favourable impact on activity rates but the overall growth of the labour force is slowing due to demographic pressures.

9. A tightening labour market, as the economy appears to operate at levels close to full employment, raises risks of overheating. Despite falling unemployment, however, wage growth remained relatively weak in 2017. That was partly a reflection of compositional changes in the labour force, as demographic trends resulted in the exit of highly skilled workers. Moreover, there were significant geographic disparities in economic performance. However, data in early 2018 suggest some acceleration in wage growth, which will be supported further by the planned fiscal loosening.

10. Despite continued economic expansion, inflationary pressures have remained muted so far. The Federal Open Market Committee's preferred inflation measure — the growth deflator for personal consumption expenditures, excluding food and energy — remains persistently below target. Although the preferred inflation measure has been climbing in the second half of 2017, the year ended with annual growth at 1.5 per cent, with the overall headline inflation at 2.1 per cent and advancing to 2.3 per cent by February 2018. However, the decline of bond prices, leading to rising yields, points to rising inflation expectations, which accelerated markedly in early 2018. The break-even inflation rate derived from 10-year bonds grew rapidly, although it stabilized in early 2018.

11. Expectations of higher inflation as the economy powers ahead have driven the Federal Open Market Committee to gradually tighten monetary policy, raising interest rates three times in 2017 by a cumulative 75 basis points and, since October 2017, reducing its balance sheet. The Committee is expected to continue to remove policy accommodations as the labour market tightens further and the pace of wage growth accelerates. In December 2017, it announced that three additional interest rate increases would be justified in 2018. In March 2018, it delivered another interest rate increase of 25 basis points, while upgrading growth projections at the same time. Given the anticipated strength of the economy, it is possible that the pace of tightening might be faster than initially envisaged.

12. The impact of monetary tightening on financial conditions has been mitigated by booming equity markets. The sustained economic recovery has been accompanied by rising equity valuations, as the stock market rose by some 25 per cent in 2017. On the other hand, rising asset prices have created some concerns about potential risks to financial stability. Housing prices continued to climb and, on some measures, are currently above previous peaks. Overall household-debt-servicing payments as a percentage of personal disposable income remained relatively stable in 2017 and, at around 10 per cent, very low by historical standards. Moreover, the weakening of the United States dollar has also contributed to easing financial conditions. The nominal trade-weighted dollar exchange rate slid by 6.7 per cent in 2017 and has continued to fall in 2018.

13. The announced tax reforms will add to the existing growth momentum. However, the expansionary impact of fiscal loosening in an economy that is already very close to full employment may be partly offset by a pace of normalization of monetary policy that turns out to be faster than anticipated.

14. The acceleration of growth has been associated with the further decarbonization of the economy. According to the International Energy Agency though global carbon dioxide emissions increased in 2017, they fell by 0.5 per cent in the United States. That was the third year of falling emissions, resulting from a switch from coal to gas and, in 2017, from an increase of renewables in energy generation.¹

15. While the economic outlook is positive, there are also some risks and sources of uncertainty. Financial vulnerabilities may have built up following a period of very lax financial conditions, and those vulnerabilities may become apparent as interest rates increase. Increased leverage in the corporate sector makes it more exposed to changes in financing conditions. Given the slow rate of growth in the labour force, a substantial acceleration in productivity is required to deliver sustained expansion rates. Improved trends with regard to investment will contribute to more favourable productivity dynamics. However, the ageing of the population and a rising dependency ratio is likely to have a negative impact on productivity. Emerging trade tensions may contribute to uncertainty and raise undesirable spillover effects.

16. In Canada, the pace of economic expansion doubled in 2017 as GDP increased by 3.0 per cent. Domestic demand, including the acceleration of private consumption and the recovery of investment after two years of contraction, drove growth as energy prices firmed up. The unemployment rate is at a level below what it was before the global financial crisis, fuelling the growth of earnings. A moderately expansionary fiscal policy also contributed to economic dynamism, although infrastructure spending remained below planned levels.

17. Housing prices in Canada have risen rapidly, supported by favourable lending conditions and net migration. The accumulation of housing-related risks in the banking sector has created some concern among monetary authorities. The ratio of household debt to GDP now exceeds 100 per cent. A withdrawal of monetary stimulus has started as growth has accelerated. The central bank, after raising interest rates twice in 2017, delivered a new increase in early 2018 while warning that uncertainty over the future of the North American Free Trade Agreement was clouding the economic outlook.

¹ International Energy Agency, "Global energy & CO₂ status report 2017" (March 2018). Available from www.iea.org/publications/freepublications/publication/GECO2017.pdf

IV. Advanced European countries

A. Euro area

18. Economic prospects have brightened in the euro area and a broad-based recovery has been gaining momentum. Economic activity turned out stronger than initially expected in 2017, as GDP growth accelerated to 2.3 per cent from 1.8 per cent in 2016. It was the first time since 2007 that all countries reported positive growth. A significant divergence in the pace of recovery among countries persists, as the rapid expansion in Germany and Spain contrasts sharply with the sluggish performance in Italy. The expansion is expected to continue at a similar pace in 2018, amid a supportive external environment, a still-accommodative monetary policy and a broadly neutral fiscal policy. However, some deceleration is anticipated, with a moderation of sequential growth, as the factors that initially propelled the recovery, including low oil prices and a weak euro, have reversed.

19. Domestic demand has been a major driver of the expansion. The growth of consumption, in particular, has been fuelled by higher employment and increasing labour participation. Overall, the recovery following the global financial crisis in 2008 and the euro area turmoil in 2012 has been characterized by relatively weak investment. However, as the expansion has become more sustained and synchronized, a growing cyclical momentum has emerged, supported by the increase in global activity and trade. The reduction of uncertainty, high-capacity utilization rates and persistent growth in demand has boosted investment, in particular with regard to equipment, while residential investment is trailing behind. Investment surveys point to further acceleration in 2018, amid still-easy financing conditions.

20. Despite the appreciation of the euro, a favourable external environment has supported the expansion of European exports. Unlike in 2016, net external demand made a positive contribution to GDP growth. However, an excessive strengthening of the euro could damage growth prospects. The dynamics of the exchange rate remain a source of uncertainty that influences future inflation and growth.

21. Unemployment continued to fall across the euro area. There are, however, significant differences across the subregion. Labour shortages in particular sectors in some countries are in sharp contrast to double-digit unemployment rates in others. A large gap exists between age groups. While the unemployment rate fell to 7.8 per cent for those between the ages of 25 and 74 by the end of 2017, it was at 17.9 per cent for those under the age of 25. Overall, the number of employed people reached record levels, but the number of hours worked is still below what was observed before the global financial crisis, which suggests the presence of continued slack in the labour market.

22. Despite falling unemployment, wage pressures have remained largely absent. In particular, German wage growth has remained muted. Negotiated monthly earnings rose by 2.5 per cent in 2017, up from 2.0 per cent in 2015–2016, and are still below increases observed in 2012–2014, despite a booming economy. The country accounts for almost one third of the harmonized index of consumer prices for the euro area and therefore has a significant influence in overall inflation dynamics. There are different factors that may have contributed to those limited wage increases. In particular, deep trade integration and the expansion of production networks into neighbouring low-cost Central and Eastern European countries are likely to have had dampening effects.

The increased importance of global value chains² contributes to explaining the influence of global conditions in domestic inflation. Large migratory inflows and rising labour participation rates have also had a positive impact on labour supply, thus moderating wage pressures. Research by Deutsche Bundesbank suggests that migration from other member States of the European Union has had an influence in reducing wage pressures in recent years. However, there are indications that wage growth could increase in 2018, as suggested by ongoing negotiations between trade unions and employers, although that could be limited to some unionized sectors.³

23. Fixed exchange rates in a monetary union such as the euro area imply that external adjustment to imbalances across euro area members need to take place through differential inflation rates, which will be the drivers of changes in real exchange rates. In practice, and leaving aside the impact of the evolution of productivity, that means that the dynamics of inflation in Germany, where external rebalancing requires real appreciation, would constrain overall inflation in the euro area over the medium to long term.

24. Headline inflation rose slightly, boosted by higher demand, reaching 1.4 per cent by the end of 2017, up from 1.1 per cent one year earlier. However, core inflation, excluding energy and food, remained unchanged, and has been around 1 per cent over the past four years. That has resulted in persistently low inflation expectations. Yields on sovereign bonds have increased, in particular in early 2018, but remain moderate. For the highest-rated borrowers, they are still negative in real terms. Inflation is expected to increase in 2018 as a result of higher oil prices and increased demand pressures emanating from a synchronized recovery, but those influences will be mitigated by an appreciating exchange rate. Deflation is no longer a concern, given the strength of the recovery, high-capacity utilization and declining unemployment rates. However, the emergence of significant inflationary pressures remains an unlikely development.

25. The recovery has gained further momentum, but it is still supported by a very accommodative monetary policy. However, the European Central Bank has indicated that, after years of large bond purchases, the massive monetary stimulus will be gradually withdrawn, as the inflation outlook for the euro area has changed. The Bank reduced monthly net asset purchases from €60 billion to €30 billion as of January 2018. Purchases at that pace will continue until at least September 2018. However, the reinvestment of maturing bonds in the Bank's portfolio is partly offsetting the reduction, and the impact of that will continue well beyond the end of net asset purchases. Overall, the European Central Bank will retain a substantial presence in bond markets. However, in March 2018, the Bank withdrew a previous pledge to extend the asset purchase programme if needed, showing its confidence in the strength of the recovery. The Bank intends to maintain current low interest rates until after the end of quantitative easing, with no changes anticipated until the middle of 2019.

26. Lending conditions improved further. Loans to both households and corporations continued to increase, rising by around 2.8 per cent in 2017. The health of banking systems in euro area countries has also strengthened, in line with the economic situation. However, large stocks of non-performing loans continue to weigh on the profitability and the lending capacity of that sector in some economies. By the

² Raphael Auer, Claudio Borio and Andrew Filardo, "The globalisation of inflation: the growing importance of global value chains", BIS Working Papers, No. 602 (2017). Available from www.bis.org/publ/work602.htm

³ Deutsche Bundesbank, "Monthly report, November 2017", vol. 69, No. 11 (November 2017). Available from www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report/2017/2017_11_monthly_report.pdf?__blob=publicationFile

end of the third quarter of 2017, the ratio of non-performing loans to total loans was in double digits in six countries in the euro area.

27. After bottoming out in 2014, the growth in housing prices accelerated slightly in 2017. The wealth effect of higher housing prices is having a positive influence on consumption. While nominal prices were 7 per cent above the pre-crisis peak level in the third quarter of 2017, in real terms they remained at levels observed in mid-2011. Much faster growth was observed in the European Union as a whole, where housing prices have already reached the record levels registered before the global financial crisis in real terms. There are also significant country differences, as prices in Spain and Italy are still only around three quarters of past record levels.

28. After a sustained period of accommodative monetary policy, the transition to a more normal policy stance raises some policy concerns. Financial imbalances, the misallocation of capital and the mispricing of risks that may have built up under lax financial conditions could become apparent as the pace of economic activity increases and prompts some monetary policy tightening. That may lead to large asset price corrections with undesirable consequences. In particular, risk premiums in sovereign debt markets have fallen partly due to continued bond purchases by the European Central Bank. Reduced intervention by the European Central Bank may increase the vulnerability of peripheral bonds to market sentiment. Debt levels in the non-financial corporate sector are high and are therefore a source of risk if financial conditions tighten.

29. The fiscal position of the euro area has improved due to the cyclical recovery and persistent low financing costs. In 2017, no new Excessive Deficit Procedures were opened, and the Procedures for Greece, Portugal and the United Kingdom of Great Britain and Northern Ireland were abrogated. Spain was the only country to post a deficit above 3 per cent in 2017, but the deviation from that threshold was marginal and within target, due to the strong growth in revenues. However, although fiscal balances are converging, debt burdens are very different, which has important implications for fiscal space. There are a number of high-debt countries that may suffer from rising borrowing costs as financial conditions become tighter. In contrast, other countries have the opportunity to boost overall public investment and spending on infrastructure, thereby contributing to the rebalancing in the euro area. Public debt as a share of GDP has been falling in Germany since 2010, but it is still above 100 per cent in Belgium, Cyprus, Greece and Italy. Greece successfully went back to capital markets in the summer of 2017, which showed the progress made in returning to financial normality; however, it also reflected the continued search for yield by investors in a low-interest environment.

30. Discussions on the reform of the institutional architecture of the euro area have been ongoing, including with regard to different initiatives for financial risk-sharing. In December 2017, the European Commission released a road map for deepening Europe's economic and monetary union, which contained a number of proposals, including the establishment of a European monetary fund to assist members in financial distress, on the basis of the existing European Stability Mechanism, and new budgetary instruments to support stability.

31. The euro area continued to show a large current account surplus, equivalent to 3.5 per cent of GDP. Differences in competitiveness led to the building of imbalances in the pre-crisis period. As financing became scarce, countries in the periphery that had large current account deficits were forced to adjust, largely through import contraction resulting from demand compression. There have also been successes in improving external competitiveness. In Spain, exports as a share of GDP are now around 10 percentage points above 2007 levels. With the exception of Greece, all those peripheral countries are running current account surpluses, which means that

they are net providers of finance to the rest of the world. Unlike the situation before the global financial crisis, they are not dependent on large capital inflows. However, no symmetric adjustment has been seen in surplus countries. In Germany, which accounts for around two thirds of the current accounts surplus in the euro area, the surplus only declined marginally in 2017 and remained close to 8 per cent of GDP.

32. The improved economic outlook provides a more auspicious environment to undertake necessary structural reforms that raise productivity rates, reduce environmental pressures and foster inclusiveness. Slow productivity growth remains a major concern, although there are some promising trends. One of the factors that explained sluggish productivity trends was low investment levels, but the sustained recovery is now being accompanied by more robust spending on equipment. Higher productivity would relieve inflationary pressures and the dampening impact on growth of an ageing population.

33. Gross fixed capital formation as a percentage of GDP remains, however, below the levels observed before the global financial crisis. Sustained underinvestment, in particular in critical areas such as transport or energy infrastructure, has reduced the growth potential of the economy. It has also prevented the ability to address looming environmental problems more quickly. According to the European Investment Bank, investment in climate change mitigation in the European Union as a whole declined from 1.6 per cent of GDP in 2012 to just 1.2 per cent in 2016.⁴

34. Convergence in real income across countries stagnated in the early years of the euro area and reversed during the global financial crisis. Low growth in productivity in some countries combined with initially lower productivity levels contributed to that adverse development for the cohesion of the monetary union. During the financial boom, cross-border capital flows financed investments in sectors such as housing and real estate, where productivity increases are limited, and so did not make a contribution to sustainable income convergence. Infrastructure investment has been negatively affected by past efforts regarding fiscal consolidation, as capital expenditures were a major target for cuts. Declines in infrastructure spending have been largest in countries with the poorest infrastructure quality, thus impairing real convergence.

35. The recovery has been accompanied by a reversal of some of the negative effects on poverty and income inequality associated with the crisis. Fiscal redistribution is an important policy instrument to mitigate inequality. According to the European Commission, redistribution through the tax systems in the European Union managed to lower income inequality by around one third from 2004 to 2014, and is the main reason for the fact that household inequality in the European Union is much lower than in the United States.⁵

36. While overall household income inequality has remained almost unchanged over the last decade, there are significant disparities across age groups when considering poverty dynamics. The share of people at risk of poverty and social exclusion rose from 21.7 to 23.1 per cent from 2008 to 2016. However, a sharper increase took place for those between the ages of 18 and 24, from 26.4 to 30.3 per cent, while the share of people at risk of poverty and social exclusion declined for those aged 65 years or older. The different dynamics are the result of labour market developments but also, in many countries, of the design of social protection systems.

⁴ European Investment Bank, Investment report 2017/2018: from recovery to sustainable growth (November 2017). Available from www.eib.org/attachments/efs/economic_investment_report_2017_en.pdf

⁵ European Commission, *Report on Public Finances in EMU, 2017*, Institutional Paper 069 (Luxembourg: Publications Office of the European Union, 2018). Available from https://ec.europa.eu/info/sites/info/files/economy-finance/ip069_en.pdf

which are geared more towards the protection of pensioners. Addressing the multiple implications of ageing while ensuring intergenerational equity remains a challenge.

B. Other advanced countries

37. Growth was better than expected in the United Kingdom following the outcome of the referendum on membership in the European Union in June 2016. The immediate negative implications for investment were less than anticipated, but consumption suffered as the depreciation of the pound sterling fuelled inflation and reduced real incomes. Externally oriented sectors performed comparatively better, benefiting from a stronger competitive position. Overall, GDP growth decelerated to 1.7 per cent in 2017 from 1.9 per cent in 2016. That slowdown contrasted with a more robust performance by the country's main trading partners and the strength of the global economy. Sluggish growth and falling unemployment have resulted in weakened productivity trends. The expansion of the labour force was an important driver of economic activity in the United Kingdom over the past decade, but was accompanied by poor productivity performance. The reduction of net inward migration after the referendum on membership in the European Union has also weighed negatively on growth.

38. Inflation overshoot the target of 2.0 per cent to reach 3.0 per cent at the end of 2017. The depreciation of the pound sterling and the reduction of the slack in the economy have prompted a change in the inflation outlook. The Bank of England raised interest rates by 25 basis points for the first time in a decade in November 2017, starting the normalization of monetary policy. However, financial conditions remain highly accommodative and continue to provide support to economic activity.

39. Economic prospects in the United Kingdom remain linked to the outcomes of the negotiations on leaving the European Union. In March 2018, an agreement was reached on a transition period of 21 months after March 2019, which is conditional on the conclusion of a withdrawal treaty. During that period, the United Kingdom will continue to abide by the rules of the European Union and will participate in its customs union and single market. That will give governments and businesses further time to plan, but the final details of the withdrawal from the European Union remain undefined. The associated uncertainty will continue to weigh on economic prospects.

40. Economic performance was generally positive in Scandinavian countries. In Norway, the reversal of declines in oil prices boosted economic activity and GDP growth accelerated from 1.1 per cent to 1.8 per cent in 2017, supported by an increase in household consumption and a sharp turnaround in investment. In Sweden, growth was robust. Investment, in particular in housing, made a large contribution to the estimated 2.7 per cent increase in GDP in 2017. However, some data indicating softer economic sentiment emerged in early 2018. In Denmark, growth accelerated slightly to 2.1 per cent in 2017. The turnaround in net external demand, which accounted for almost one quarter of the observed expansion, offset the deceleration of consumption and investment. However, that performance was boosted by a large payment for the use of a patent, which was booked as a services export, which raised the growth rate by 0.4 percentage points, according to Statistics Denmark. That example illustrates the limitations of using GDP to assess domestic activity in a small, open economy such as Denmark or Ireland.

41. Housing prices have been increasing rapidly in recent years in Scandinavian countries, particularly in the capitals. In Denmark, a sharp adjustment in housing prices followed the global financial crisis, but prices recovered afterwards. Household debt is large in Scandinavian countries and monetary authorities have expressed concerns over emerging financial risks. In Denmark, besides the strengthening of

macroprudential policies, property valuation and taxation have been reformed to rein in increases in housing prices. Housing prices started to decline in the middle and/or later months of 2017, depending on the country, which has reduced the likelihood of a larger adjustment.

42. Monetary policy has been very accommodative, which has supported increases in housing prices. Policy rates remain at record lows in Sweden (-0.50 per cent) and Norway (+0.50 per cent). Although inflation has increased, particularly in Denmark, and is expected to increase further, it remains low. In Sweden, inflation peaked in July 2017 and has been falling since then.

43. Growth remained moderate in Switzerland in 2017, as the strong Swiss franc dampened economic activity. Despite some weakening, the exchange rate remained around 20 per cent above the level before the global financial crisis in real trade-weighted terms. Inflation returned to positive territory, after five years of deflation boosted by higher oil prices and the depreciation of the Swiss franc. Overall, wage and price pressures remain very weak. The pace of expansion of economic activity is expected to accelerate significantly in 2018, boosted by the further depreciation of the Swiss franc and favourable international conditions.

V. Emerging economies

A. New European Union member States

44. Economic performance was robust in 2017, and output expanded at the fastest rate of growth in a decade, rising from 3.2 per cent in 2016 to 4.8 per cent. The upswing in the rest of the European Union has created a favourable environment for economic activity, while policies are supportive of growth. The expansion will moderate in 2018 but remain robust, as the positive external circumstances are expected to continue. The rapid pace of expansion observed implies further progress in reducing the income gap with member States that joined the European Union earlier. The growth differential is above 2 percentage points, as observed in the years before the global financial crisis, thus contributing to economic convergence.

45. Private consumption, supported by rising real wages and household incomes, has been the main driver of the recovery. Public interventions have also boosted consumption in some countries. In Poland, transfers to families with children provided an additional source of income. In Hungary, the minimum wage increased by 15 per cent in 2017, to be followed by a further 8 per cent in 2018. In Romania, a procyclical fiscal policy fuelled the strong growth of household consumption, which drove the fastest economic expansion observed in the European Union, as GDP increased by 7 per cent.

46. Investment also gathered strength, supported by increases in fiscal transfers from the European Union, improved economic prospects and high-capacity utilization rates. The acceleration of investment was particularly strong in Hungary, as a result of a high rate of absorption of European Union funds. In Poland, public investment recovered as the pace of European Union transfers accelerated. Investment by the private sector remained subdued but is expected to increase, as new opportunities emerge from increased investment in infrastructure co-financed by the European Union. In contrast, overall investment growth in Romania was moderate, while public investment declined, due to the low absorption of European Union funds and the priority attached to current spending. In Croatia, the negative impact of the problems related to the large conglomerate Agrokor contributed to weakening investment.

47. Unemployment rates continued to decline throughout the subregion. In Croatia, despite growing employment and continued emigration, unemployment remained

high, at just below 12 per cent by the end of 2017. In contrast, in Czechia, a low unemployment rate declined further. Czechia has the lowest unemployment rate in the European Union, at 2.4 per cent as of January 2018, followed by Germany with 3.6 per cent.

48. Tightening labour markets have been accompanied by rising wages. Labour shortages have emerged in particular areas in some countries, which have been partly filled by migrant workers. Migration from Ukraine accounts for the bulk of inflows in Czechia and, in particular, Poland, where it has contributed to moderate wage pressures. The availability of skills is emerging as an investment constraint in some countries in the subregion. While migratory outflows have abated, concerns regarding skill drain remain. Over the long term, adverse demographic trends will result in declines in working-age populations, which are projected to be particularly large in Bulgaria, Poland and Romania. In Poland, the reduction of the retirement age introduced last October will further constrain labour supply.

49. Inflation, which was very low or negative in 2016, accelerated in the course of 2017. In Poland, core inflation has been oscillating at around 2 per cent over the past year, although inflation expectations are rising. In Bulgaria, after three years of deflation, prices have started to grow moderately. In Czechia, the appreciation of the exchange rate, following the floating of the koruna in April 2017, has contributed to moderate inflationary pressures. In Romania, inflation has accelerated strongly, boosted by strong demand and higher energy prices, and, at 3.8 per cent as of February 2018, is now the highest rate in the European Union.

50. Strong economic growth has boosted revenues and improved the fiscal positions of countries in the subregion. In Bulgaria, the fiscal windfall was used in late 2017 to significantly increase spending while still keeping the budget in a surplus. In Czechia, very low debt-servicing costs contributed to strengthening the country's fiscal position. Despite rapid growth in expenditures, the deficit remained at around 3 per cent of GDP in Poland. In Croatia, higher-than-expected revenues resulted in a surplus of the primary balance for the first time since the country's independence and led to a reduction of the overall deficit. The ratio of public debt to GDP, which is comparatively high, is on a downward path.

51. Monetary policy trends are diverging in the subregion. While monetary authorities in Hungary and Poland appear less alarmed by inflation so far, authorities seem more ready to tighten policies in Czechia and Romania. In Poland, interest rates have remained unchanged since March 2015. While inflation has come to an end, monetary authorities have not signalled an intention to raise rates yet. The Czech National Bank introduced a very small raise in the policy rate in August 2017, and in early 2018 started to express some concerns on the inflationary impact of wage growth. The National Bank of Romania raised the policy rates, which had been unchanged since May 2015, twice in the first two months of 2018.

52. Credit growth accelerated in the most of the new European Union member States, in particular with regard to households, but continued to contract in Croatia. Overall, credit expansion was relatively contained, as Czechia was the only country posting increases well above nominal GDP growth. Foreign bank funding generally improved, but the robust growth of domestic deposits was by far the main source of financing for the increase in lending. Unlike the situation before the global financial crisis, when foreign capital inflows were substantial, further credit expansion is likely to be constrained by the growth of domestic deposits. Banking sectors in the subregion are in better shape, although the share of non-performing loans remains high and is only declining slowly in Bulgaria and Croatia. Housing prices have also increased rapidly in recent years, although debt-to-income ratios remain well below those observed in member countries that joined the European Union earlier.

53. Current account deficits declined sharply or turned into surpluses in most countries in the subregion after the euro area sovereign debt crisis in 2012, owing to associated tensions in financial markets and their negative impact on cross-border financial flows. That implies an excess of domestic savings over investment, despite the opportunities created for faster economic growth in those economies. In Bulgaria, domestic demand replaced export-led growth in 2017 as the main source of expansion, but the current account surplus remained one of the largest in the region, at around 4 per cent of GDP. As in Croatia, the growth of tourism revenues in Bulgaria supported external balances. In Hungary, the deterioration of the trade balance led to a sharp decline in the current account surplus, which nevertheless remained close to 4 per cent of GDP. In contrast, the current account deficit in the fast-growing Romanian economy increased further, reaching around 3.5 per cent of GDP.

54. The economic prospects of the subregion are closely associated with those of the rest of the European Union, owing to their strong trade and investment links. European Union fiscal transfers under its cohesion policy have a significant impact on domestic demand, and the disbursement cycles influence the dynamics of output. While the recent performance and the immediate outlook are positive, some concerns emerge when considering the medium term. The eventual exit of the United Kingdom from the European Union is likely to result in a reduction of the financing available for transfers to countries that benefit from the cohesion policy, thus weakening the influence of an important growth driver in the new European Union member States.

B. South-Eastern Europe

55. Economic performance in the Western Balkans was mixed in 2017. Growth accelerated in Albania and, in particular, Montenegro, as both economies expanded at a rate estimated to be close to 4 per cent, while in Bosnia and Herzegovina growth remained steady at around 3 per cent. Improved economic prospects in the European Union and stronger domestic demand fuelled economic dynamism. Investment related to infrastructure continued to boost economic activity, in particular in Montenegro. Private consumption is playing an increasing role in driving the expansion of output, supported by improvements in the labour markets and, in some countries, growing remittances. Increased tourism revenues are also contributing to higher economic dynamism in Bosnia and Herzegovina and Montenegro.

56. In contrast, in Serbia, the largest economy in the subregion, growth slowed to 1.9 per cent in 2017 from 2.8 per cent in 2016. While private consumption is gathering strength, bad weather affected agriculture and the slow pace of implementation of public projects dampened investment. In the former Yugoslav Republic of Macedonia, political tensions resulted in a sharp decline in investment, and overall output remained practically flat.

57. Economic growth has created new jobs, but nevertheless unemployment remains high, particularly in Bosnia and Herzegovina and, despite the introduction of public sector programmes, in the former Yugoslav Republic of Macedonia. Youth unemployment, in particular, is a major problem throughout the subregion that continues to fuel migration.

58. Inflation in the subregion remained low, although it started to increase slightly amid strengthening domestic demand. High unemployment rates indicate a significant amount of slack in labour markets. The absence of price pressures and further progress on fiscal consolidation led the monetary authorities of Serbia to lower interest rates twice in 2017 and to deliver another cut in early 2018. In the former Yugoslav Republic of Macedonia, prices started to grow after three years of deflation.

In Albania, monetary policy remains accommodative, as inflation is still well below the target rate.

59. Stronger domestic demand led to large external deficits, in particular in Montenegro, where investment-related imports fuelled a significant gap. Large deficits create significant financing needs and make the subregion vulnerable to a deterioration in external financing conditions. Foreign direct investment, however, remains the main source of financing and increased export capacity will tend to reduce external imbalances in the future.

60. Economic prospects depend on growth dynamics in the European Union, which absorbs almost three quarters of the goods exports of the countries in the subregion. Accession to the European Union, while still a distant possibility, is providing an anchor for economic policies. It is also a source of financing, with around €1.1 billion expected to be received in 2018 in pre-accession funds. A European Commission strategy on European Union engagement with the Western Balkans⁶ was published in February 2018 that presented the indicative steps required for Montenegro and Serbia, the two countries who are already in negotiations, to complete the accession process by 2025. While the income convergence process progressed rapidly from 2000 to 2007, it has stagnated since, and GDP per capita in the subregion is only around one third of the European Union average.

61. The economic growth rate of Turkey more than doubled in 2017, as GDP expanded by 7.4 per cent amid supportive policy conditions and increasing external demand, including rising tourism revenues. The labour market has performed strongly, while absorbing a large increase in the labour force. The rapid pace of job creation and government stimulus has boosted consumption. In contrast, investment has been trailing behind. Inflation accelerated in 2017, fuelled by stronger domestic demand, the weak Turkish lira and rising energy prices. Although it has started to decline, and was at 10.3 per cent in February 2018, inflation remained well above the 5 per cent target. Monetary authorities increased some key interest rates in 2017, but monetary policy remains loose. A very large current account deficit makes the country dependent on external financing and vulnerable to a reversal in foreign capital inflows and the deterioration of financing conditions. Around half of the deficit was financed with portfolio flows in 2017, mainly public bonds, while the share of foreign direct investment declined. While demographic dynamics support long-term growth, investment and productivity trends appear less supportive of future performance.

C. Commonwealth of Independent States and Georgia

62. The pace of economic activity accelerated in 2017, marked by the return to growth in the Russian Federation after a two-year contraction. Improved terms of trade, a more supportive external environment and less-volatile macroeconomic conditions drove the recovery. Overall, GDP growth was modest and well below the rates seen in the pre-crisis period. Aggregate output of the Commonwealth of Independent States remained practically flat in 2016 and rose by around 2.1 per cent in 2017. The continuation of a supportive external environment, including improved terms of trade, is providing further support to the recovery in 2018.

63. The reaction to the oil price decline initiated in 2014 was quicker in the Russian Federation than in other energy exporters in the Commonwealth of Independent States, which allowed the exchange rate to adjust accordingly. In comparison with past contractions, the recession was much shallower. After shrinking by a cumulative

⁶ Available from https://ec.europa.eu/commission/sites/beta-political/files/communication-credible-enlargement-perspective-western-balkans_en.pdf

2.7 per cent in 2015 and 2016, GDP in the Russian Federation rose by 1.5 per cent in 2017. In contrast, the initial reluctance of other energy-exporting countries to let the currency depreciate resulted in a slower pace of adjustment. In Azerbaijan, output suffered a severe contraction in 2016 and was practically flat in 2017.

64. In Ukraine, the recovery continued for a second year, despite the company seizures and trade blockade in the east of the country. However, the negative impact of those events and the decline of agricultural production dampened economic performance. Overall, the Ukrainian economy has shrunk by around 20 per cent since 2008. Belarus came out of its recession in 2017, with strong industrial growth and a good harvest. The settlement of its dispute with the Russian Federation on oil deliveries and gas debts boosted economic prospects. In Kazakhstan, higher oil prices and increased production at the Kashagan oil field were key factors in the observed increase in growth.

65. The recovery of remittances from the Russian Federation contributed to the acceleration of economic activity in energy importers in Central Asia. In Kyrgyzstan, large increases in gold production boosted output. In Armenia, where remittances are also important, the economy has had a strong recovery, amid rapid industrial growth and higher copper prices.

66. Domestic demand was the main driver of the recovery. The Russian consumer, unlike in previous crises, suffered the brunt of the adjustment during the recent recession, but the dynamics of retail trade and mortgage lending improved amid strong real wage growth. However, consumption remained weak and trailed behind investment. In Ukraine, the minimum wage was doubled and private consumption gained momentum, but gross fixed capital formation continued to show much greater dynamism. In Kazakhstan, increasing exports also contributed to the acceleration of growth.

67. Inflation declined throughout the subregion, supported by the strengthening of exchange rates, but in some countries increases in the price of utilities contributed to an increase in inflation. In the Russian Federation, lower food prices, driven by a good harvest and the resumption of imports from Turkey, contributed to the decline of inflation, which was at 2.2 per cent by February 2018. The recovery of domestic demand and the reversal of the positive impact of exchange rate appreciation may create some inflationary pressures. In Ukraine, inflation remained at elevated levels, at 13.7 per cent at the end of 2017, well above the 8 per cent target. In contrast, inflation in Belarus fell to single digits, supported by a tight monetary policy and the reduction of directed lending. In Uzbekistan, the liberalization of currency regulations and the ongoing shift to convertibility opened new vistas for investment, but the ensuing sharp depreciation of the exchange rate pushed inflationary pressures. In Armenia, deflation came to an end in 2017 and inflation continued to increase in 2018.

68. The weakening of price pressures allowed a cautious loosening of monetary policies, although countries in the subregion are in different positions in the easing cycle. In contrast, disappointing inflation performance in Ukraine, despite the relative stability of the exchange rate, led the National Bank of Ukraine to raise rates aggressively, increasing them by 350 basis points between December 2017 and March 2018 and thereby reversing the cuts from earlier in 2017. In the Russian Federation, real rates are relatively high in comparison to other emerging markets but monetary policy is being loosened. The Central Bank of the Russian Federation cut rates by 50 basis points in December 2017 and by a further 25 basis points to 7.50 per cent in March 2018. Further cuts are expected, but recent weakening in the exchange rate may lead to a pause.

69. Employment was steady during the recent crisis, owing to wage flexibility and the use of part-time work. The current recovery is resulting in growing wage gains,

the reduction of involuntary adjustment mechanisms and declines in unemployment rates. In the Russian Federation, falling unemployment is being accompanied by a shrinking labour force, driven by demographic trends, and the emergence of labour shortages for skilled labour in some areas. In Belarus, the increase in economic growth did not lead to increased employment, owing to the impact of the ongoing restructuring of State-owned enterprises.

70. Oil prices increased in 2017, which boosted public finances in oil producing countries and also in Belarus, which benefits from oil deliveries from the Russian Federation for refining and re-exporting. Despite the recovery, prices are expected to remain much lower than before the sharp decline initiated in 2014. Energy-exporting countries continued to adapt to an environment of persistently low prices and embarked on a path of fiscal consolidation. New fiscal frameworks for the use of hydrocarbon resources were put in place. Medium-term fiscal plans imply further fiscal tightening. At the same time, an increased policy emphasis on the efficiency of public spending and its contribution to growth has emerged in the subregion.

71. Ukraine managed to contain the deficit despite increased public sector wage costs, as tax collection benefited from one-off factors and rising inflation boosted tax receipts. Privatization revenues were well below targets, however. The pension system has one of the largest deficits in the subregion, adding to the public finances gap. A pension reform was introduced in 2017 that increased the effective retirement rate.

72. The acceleration of growth and, in some countries, the strengthening of real exchange rates, was accompanied by increased imports. On the other hand, higher oil prices boosted the value of exports in energy-exporting countries, resulting in a widening of the current account surplus in the Russian Federation and a reduction of the deficit in Kazakhstan, which also benefited from increased oil exports. In Ukraine, growing remittances contributed to containing the current account deficit and offset the impact of an increased trade gap. In Belarus, the recovery of the Russian Federation and the resumption of oil deliveries from that country at normal levels greatly boosted exports.

73. In the Russian Federation, the development of some sectors, such as agriculture and food processing, benefited from import restrictions imposed as counter-sanctions. That translated into a declining share of food imports in retail trade. In Ukraine, the geographic reorientation of trade away from the Russian Federation has been accompanied by a shift in product composition to include more agricultural products. In the Russian Federation, the overall share of the European Union in total trade is falling, while the overall share of China, now the Russian Federation's largest single trade partner, increased. Trade turnover among countries of the Eurasian Economic Union grew faster than trade with other countries.

74. The subregion faced a benign environment with regard to access to capital. A number of countries, including Belarus, the Russian Federation, Ukraine and Tajikistan, took advantage of the search for yield among international investors to launch Eurobonds in 2017 and early 2018. In addition, Belarus refinanced its debt with the Russian Federation following their agreement on payments for gas arrears and a new deal on energy deliveries. In Ukraine, the recent bond issue marked the return to capital markets after the 2015 debt restructuring. Debt-servicing payments loom large in the years ahead. Although financing options have improved, low growth prospects would weigh negatively on debt sustainability in Ukraine. Eurobond proceeds in Tajikistan will be used to finance a hydropower plant.

75. The economic sanctions against the Russian Federation have prompted a process of deleveraging, particularly in the banking sector, in recent years. While the sanctions have limited financing options, they have not precluded access to foreign

funding. The share of non-residents in debt to the Russian Federation increased in 2017, while corporations have made repeated forays into international capital markets.

76. Lending, in particular with regard to households, increased in the Russian Federation and Kazakhstan. However, the banking sector remains in generally poor shape in the subregion. State support has been substantial in recent years and more will be required. In Kazakhstan, for example, government support was around 5 per cent of GDP in 2017. In Ukraine, fiscal consolidation in recent years has been remarkable, and includes the reduction of the quasi-fiscal deficits in the gas sector. However, the cost of restructuring the banking sector looms large and will contribute to the deterioration of public debt ratios. In the Russian Federation, despite recent success in stabilizing the financial system, the Central Bank needed to intervene to rescue the largest private bank, as concerns over its health led to massive withdrawals of deposits. In Tajikistan, the past collapse in remittances created serious problems for the sector, which remains in a fragile situation. Overall, problems in the banking sectors constrain progress in economic diversification.

77. While economic prospects have improved, geopolitical concerns remain. The export capacity of Ukraine has been damaged by its loss of control over resources in the eastern part of the country. New sanctions against the Russian Federation have been introduced by the United States that concern, among other issues, Russian export pipelines and could also target sovereign debt. Sanctions have obvious negative effects, including raising the cost of capital, undermining confidence and making access to technology more difficult. In the short term, however, they have prompted the development of some sectors and reduced reliance on foreign financing. Unlike in 2014, recent sanctions are being imposed in a context of rising oil prices.

78. Despite the recovery and anticipated continued expansion, there is a lack of economic dynamism in the subregion. Once more, the recent downturn has exposed the subregion's vulnerability to falling commodity prices and its need to accelerate progress on economic diversification. Changes in the economic structure require sufficient levels of investment, which are comparatively low in relation to other emerging economies. Moderate growth prospects have increased policy interest in structural reforms.



Economic and Social Council

Distr.: General
27 April 2018

Original: English

2018 session

27 July 2017–26 July 2018

Agenda item 15

Regional cooperation

Overview of economic and social conditions in Africa, 2018

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith an overview of recent economic and social developments in Africa for 2018.

18-06786 (E) 210518



Please recycle



Overview of recent economic and social developments in Africa

[Original: Arabic, English and French]

Summary

Africa's economic growth performance modestly recovered in 2017 after experiencing its lowest levels in 2016 since the beginning of this century. It expanded due to the slight increase in commodity prices and improved domestic conditions supported by improved macroeconomic management. Growth in private consumption and increase in investments led the recovery, despite adverse weather conditions and fragile global economic conditions that affected some countries. Fiscal deficits declined due to fiscal consolidation, signifying continued commitment to sound macroeconomic management practices. However, relatively high fiscal deficits coupled with exchange rate depreciations have put pressure on rising public debt levels in some countries.

Monetary policies varied across African countries, as interest rates slightly declined compared to their 2016 levels. Countries reduced their interest rates in light of an improving inflation outlook to enhance demand and growth, while others increased their interest rates in an attempt to curb inflation after devaluing their currencies.

In spite of the strong growth witnessed in most countries in Africa since the early 2000s, poverty reduction has been slow and the number of people living in extreme poverty on the continent has been almost constant since 2002. The slow pace of poverty reduction is driven by high initial inequality and rapid population growth, among other factors. With an average Gini coefficient of 0.44 among its countries, Africa has the second highest inequality in the world. It also has the fastest rate of population growth in the world. The big push for universal education over the past 20 years has helped to ensure that nearly all children attend school and that gender parity is close at the primary education level. Gender gaps in primary education have largely been closed. But considerable gaps remain across subregions in access to secondary and higher education. Low levels of education combine with poor conditions of work and low remuneration to limit women's opportunities to obtain a fair return on their labour. Growth is expected to rebound in 2018, mainly driven by continued prudent macroeconomic management and strong domestic demand, underpinned by increasing public and private investment. However, slow growth recovery in advanced and emerging economies and the tightening of financial markets in developed economies, together with weather-related shocks, remain a regional risk. Recent developments in the global economy demonstrate that the dependence of Africa on commodity exports is not sustainable, hence the call for diversification in African economies and the enhancement of efforts to foster value addition through industrialization and structural transformation of the economies.

Contents

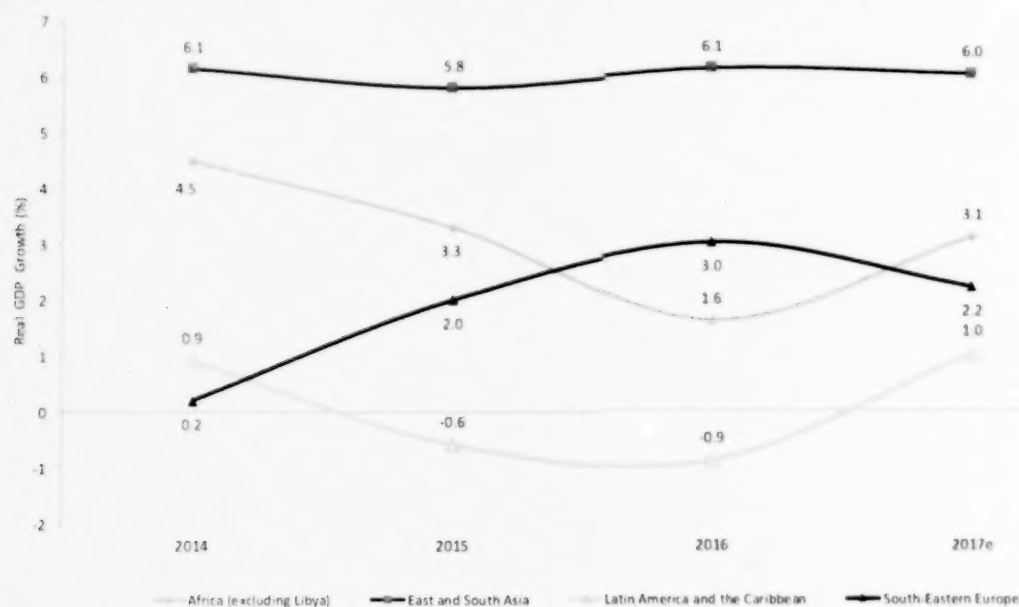
	<i>Page</i>
I. Africa's growth rebounds in 2017	4
II. Improvement in Africa's trade performance	9
III. Positive medium-term growth prospects, risks and uncertainties	13
IV. Recent social developments	14
V. Conclusions and policy implications	18

I. Africa's growth rebounds in 2017

1. Africa's economic growth performance modestly recovered in 2017, rising to 3.1 per cent,¹ after experiencing its lowest level (1.7 per cent) in 2016 since the beginning of this century. Africa is the second fastest-growing region after East and South Asia (6 per cent), followed by South-Eastern Europe (2.5 per cent), and the Latin American and Caribbean region (1 per cent) (see figure 1).

Figure 1

Economic growth in Africa and developing regions, 2014–2017



Source: Based on data from the United Nations Department of Economic and Social Affairs (2017).

Note: "e" refers to estimates.

2. Africa's economy expanded due to the slight increase in commodity prices and improved domestic conditions supported by improved macroeconomic management. Growth in private consumption and increase in investments led the recovery in Africa's growth, despite relatively low commodity prices, adverse weather conditions and fragile global economic conditions, which affected some countries. The recovery in some major economies (such as Angola, Morocco and Nigeria) and the continued robust growth in other economies (such as Côte d'Ivoire, Ethiopia, Ghana, and the United Republic of Tanzania) underpinned the continent's growth. Nevertheless, low growth performance in large economies muted the continent's growth, including in Nigeria (0.9 per cent) and South Africa (0.6 per cent).

3. However, the recent growth rates registered in both 2016 and 2017 are below the 7 per cent Sustainable Development Goals target and could not significantly reduce poverty in the continent where 41 per cent of the population lives below the poverty line.² The continent should therefore ramp up efforts to boost growth by

¹ Excluding Libya.

² See Kathleen Beegle and others, *Poverty in a Rising Africa* (Washington, D.C., World Bank, 2016).

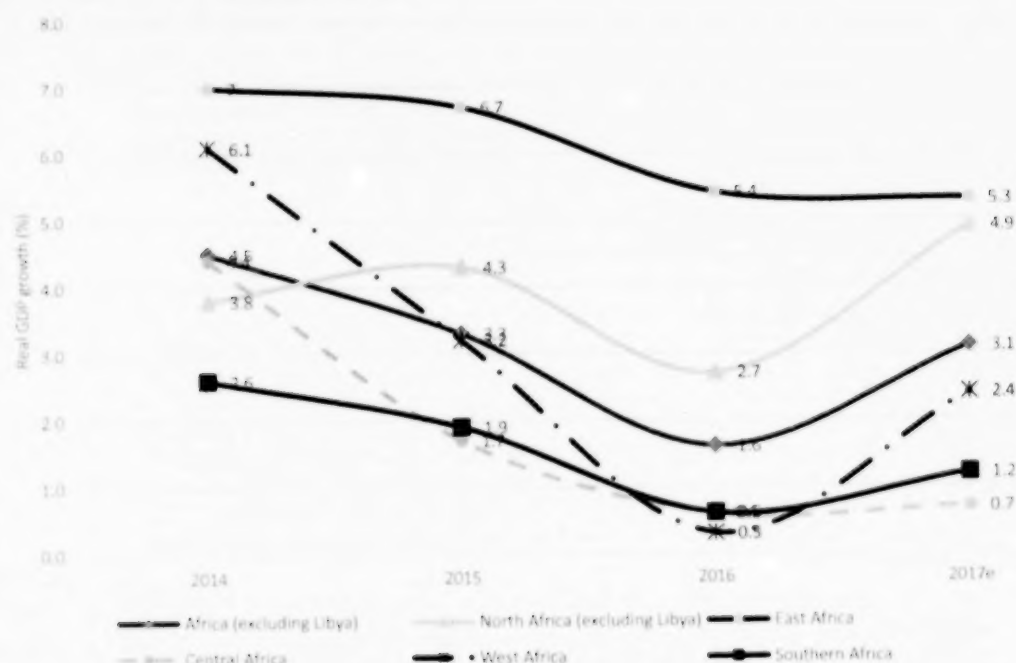
underscoring the importance of measures to promote shared growth, through structural transformation and job creation. In order to enhance Africa's economic performance and move towards the 7 per cent target mentioned previously, domestic demand needs to be strengthened. Government spending on infrastructure needs to be aggressively increased to fill the infrastructure gap in Africa. The rise in public investment should not cause any further deterioration in fiscal balances and African Governments need to continue their efforts to consolidate their fiscal position. Enhancing tax administration, fighting illicit capital outflows, and tapping excess liquidity in the banking sector are potential sources to finance public investment, particularly in infrastructure.

A. Growth recovery across many subregions

4. Eastern Africa continues to be in the lead with an annual growth rate of 5.3 per cent in 2017, followed by North Africa at 4.9 per cent, West Africa at 2.4 per cent, Southern Africa at 1.2 per cent and Central Africa at 0.7 per cent (see figure II). Growth in Eastern Africa is driven by strong private consumption, increase in investments and government expenditure on infrastructure (especially in the energy and transport sectors), in countries such as Ethiopia, Kenya, Uganda and the United Republic of Tanzania. In North Africa, economic growth continues to be driven by agricultural production in Morocco and the Sudan. Egypt embarked on a major economic reform programme, involving fiscal consolidation measures and business environment reforms.

5. Growth in Central Africa is underpinned by growth in Cameroon, which is driven by robust government spending and an increase in external demand. In the Central African Republic, growth is spurred by a modest increase in private and public consumption, while in the Republic of the Congo, growth is driven by modest public investment in infrastructure. Equatorial Guinea and Gabon recovered from last year's deceleration in growth due to oil price decline, while Sao Tome and Principe continues to enjoy healthy growth led by improvements in the agriculture and tourism sectors.

Figure II
Economic growth by subregion, 2014–2017



Source: Based on data from the United Nations Department of Economic and Social Affairs (2017).

Note: "e" refers to estimates.

6. In West Africa, Nigeria grew by 0.9 per cent — as the country launched its Economic Recovery and Growth Plan for 2017 to 2020, with reforms aimed at diversifying the economy — on the back of increasing oil exports. Countries such as Burkina Faso, Côte d'Ivoire, Ghana and Senegal led growth in West Africa, which increased from 0.3 per cent in 2016 to 2.4 per cent in 2017. Growth in those countries was due to a rise in private and public consumption and improved oil exports.

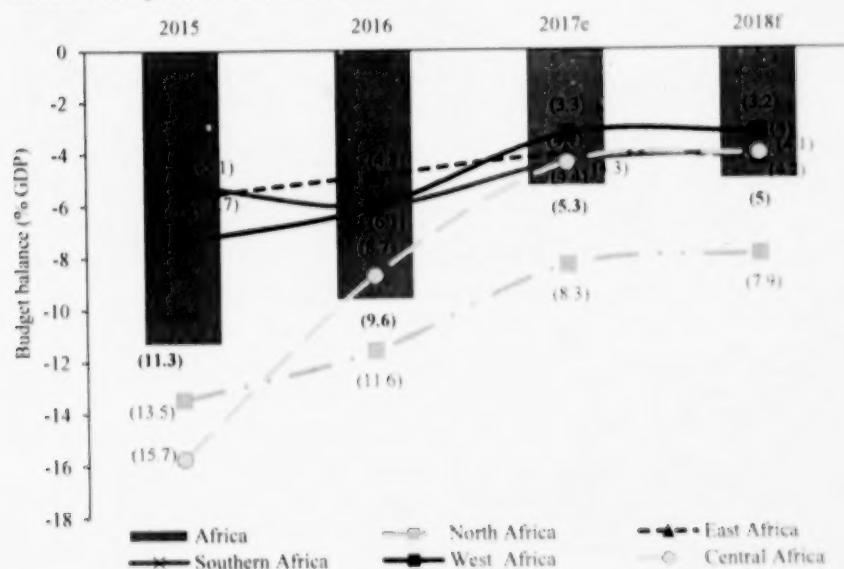
7. Growth in Southern Africa increased from 0.6 per cent in 2016 to 1.2 per cent, reflecting the recovery in the subregion's big economies of Angola (driven by improved private and government consumption) and the weak growth in South Africa. The recovery of agricultural production following the end of a drought has helped reduce inflation in the subregion, complemented by the loosening of the monetary policy in most countries.

B. Africa's fiscal deficit is narrowing albeit high

8. The overall fiscal deficit share in gross domestic product (GDP) declined due to fiscal consolidation through the reduction in fiscal expenditures and raising or introducing new taxes. Fiscal deficits declined by 0.7 percentage points from 5.9 per cent in 2016 to 5.2 per cent in 2017 and are projected to decline further to 4.9 per cent in 2018. While underlying factors behind the fiscal shortage vary across countries, this trend demonstrates continued commitment to sound macroeconomic management practices through fiscal consolidation boosted by the slight recovery in commodity

prices since early 2016. All the subregions and economic groups registered an improvement in their fiscal positions in 2017, a trend projected to continue in 2018 (see figure III). However, in some countries, fiscal deficit widened as a result of increased public expenditure, especially on infrastructure development.

Figure III
Fiscal deficit position in Africa, 2015–2018



Source: ECA calculations based on 2017 data from the Economist Intelligence Unit database, see www.eiu.com.

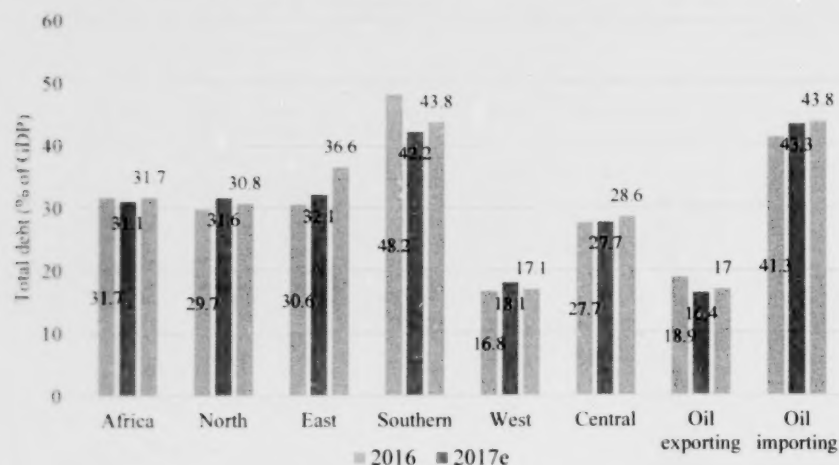
Note: "e" refers to estimates, "f" refers to forecasts.

9. It is important for many countries to improve their tax administration practices. Based on a 2017 report of the African Tax Administration Forum, African countries have on average a tax-to-GDP ratio of 19.1 per cent, which is below that of Latin America and the Caribbean (22.8 per cent). While African economies have made significant progress in increasing the tax-to-GDP ratio by an average of 5 per cent since 2000,³ they continue to face the challenge of a large informal sector and a narrow tax base. Governments need to design and implement coherent and integrated strategies to facilitate the transition from the informal to the formal economy.

10. Relatively high fiscal deficits coupled with exchange rate depreciations have put pressure on rising public debt levels in some countries as Africa's total debt share in gross domestic product hovers around 32 per cent (see figure IV). It is elevated to levels above 40 per cent in Southern Africa and among oil importing countries. Significant non-concessional borrowing for infrastructure development has led to high debt-servicing costs in several countries, such as Botswana and Mozambique.

³ African Tax Administration Forum, 2017, African Tax Outlook. Pretoria. Available at www.ataftax.org/en/products-services/african-tax-outlook.

Figure IV
Total debt share in gross domestic product in Africa, 2016–2018



Source: ECA calculations based on 2017 data from the Economist Intelligence Unit database, see www.eiu.com.

Note: "e" refers to estimates.

11. This aggregate picture, however, masks the significant debt levels in 13 countries, three of which, all small island developing States, have debt shares above 100 per cent of their GDP (Cabo Verde: 111 per cent; Mauritius: 117.5 per cent; and Seychelles: 165 per cent); four with debt shares between 76 and 100 per cent (Djibouti: 80 per cent; Mauritania: 75.4 per cent; Sao Tome and Principe: 84 per cent; and Tunisia: 79 per cent); and the remaining six with debt shares between 50 and 75 per cent (Gambia: 69 per cent; Ghana: 52 per cent; Liberia: 51 per cent; Namibia: 50 per cent; Senegal: 53 per cent; and Zimbabwe: 69 per cent).⁴ The rising public debt levels, currency depreciations and growing recourse to non-concessional borrowing for infrastructure development are fast raising debt-servicing costs, thereby diminishing fiscal space for the affected countries.

C. Varying monetary policy stance among African countries

12. Monetary policies varied across African countries in 2017, as interest rates slightly came down compared to their levels in 2016. The decline allowed several countries, including Uganda, the United Republic of Tanzania and Zambia to reduce their interest rates. Countries such as Ghana, Malawi and South Africa reduced their interest rates in light of an improving inflation outlook to enhance demand and growth, while countries such as Algeria, Angola, Kenya, Mauritania and Morocco kept interest rates at the 2016 level. Countries belonging to the Central Bank of West African States have continued to maintain their interest rate at 2.5 per cent since September 2013. However, countries such as Egypt, Ethiopia, Tunisia and the Central African Economic and Monetary Community (CEMAC) countries increased their interest rates in 2017 in an attempt to curb inflation after devaluing their currencies. Monetary policies in Africa are mainly driven by the movements in the balance of

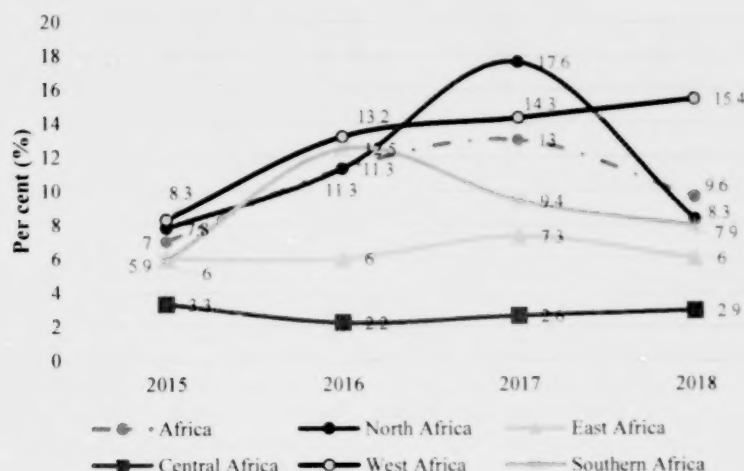
⁴ ECA calculations based on 2017 data from the Economist Intelligence Unit database, see www.eiu.com.

payments, which make it difficult for policymakers to use monetary policies to achieve sustainable development.

13. Inflation remains high in Africa, recording 13 per cent in 2017 from 11.3 per cent in 2016, mainly due to the effect of rising oil prices and currency devaluations which have pushed up import costs and exacerbated inflationary pressures, despite being offset by increased agricultural production in some of the countries, especially in Southern Africa (see figure V). Inflation continues to be relatively low in the Central African Economic and Monetary Community and the West African Economic and Monetary Union (WAEMU) countries, reflecting the stable peg to the euro.

Figure V

Inflation by subregion, 2015–2018



Source: Based on data from the United Nations Department of Economic and Social Affairs (2017), and the Economist Intelligence Unit (2017).

Note: 2017 refers to estimates; 2018 refers to forecasts.

14. Despite the currency devaluations leading to high inflation rates in several large African economies, including Angola, Egypt and Nigeria, the high exchange rate volatility witnessed by a large number of African currencies in 2016 weakened and currencies became more stable in 2017 and the countries' exports increased. However, the local currencies remain vulnerable to increased global risks such as low global commodity prices, slow growth recovery in emerging and developed countries and the tightening of global financial markets.

II. Improvement in Africa's trade performance

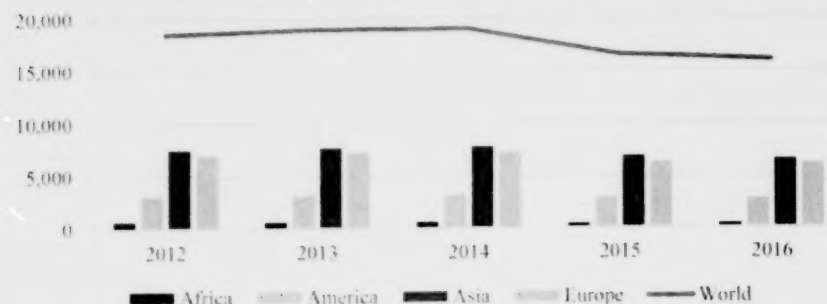
15. Africa's merchandise exports grew by 8.9 per cent in 2017, twice the global trade growth of 4.3 per cent, due to the recovery in the global economy, especially that of Africa's trading partners and the overall recovery in global trade activity (see figure VI).⁵ Global merchandise exports picked up following the global financial crisis, but since 2014, that trend has reversed, with Africa experiencing significant declines compared to other regions. Africa's merchandise exports declined by

⁵ *World Economic Situation and Prospects* (United Nations Department of Economic and Social Affairs, New York, 2017).

29.6 per cent and 11.5 per cent in 2015 and 2016, respectively, compared to 10.9 per cent and 3.7 per cent in America, 12 per cent and 4.5 per cent in Asia, and 14 and 1.3 per cent in Europe. This slowdown has largely been driven by the 2014–2015 collapse in global commodity prices, particularly for oil. Africa's share in global exports continued to fall, from 2.9 per cent in 2014 to 2.2 per cent in 2016.

Figure VI

Merchandise exports by region (in billions of United States dollars), 2012–2016



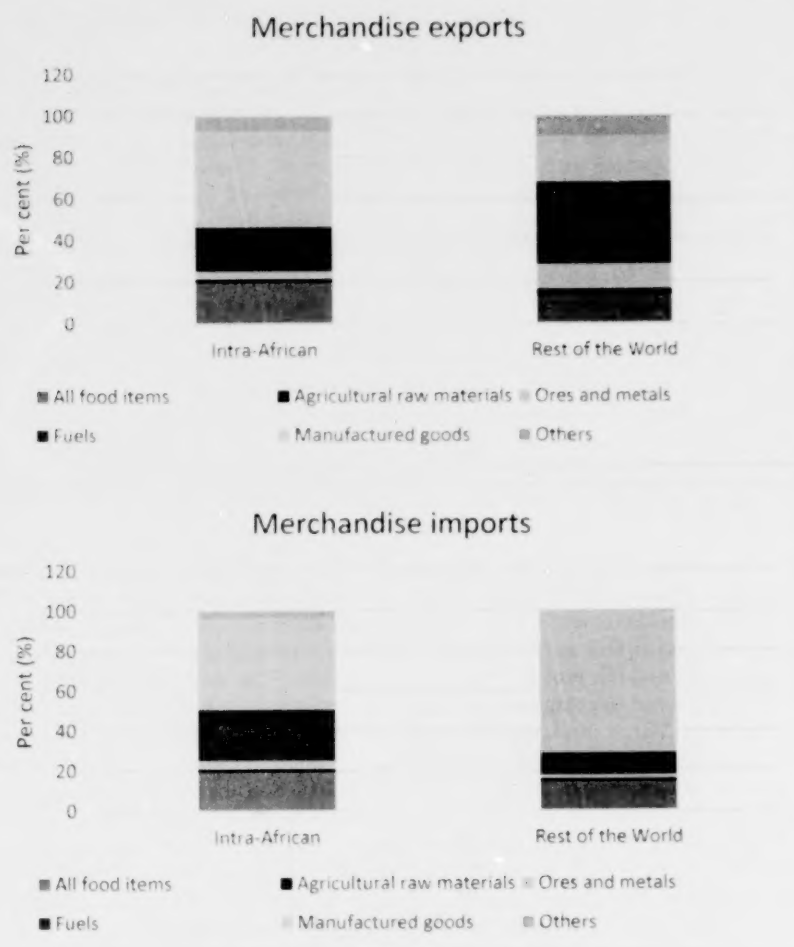
Source: ECA calculations based on UNCTAD 2017.⁶

16. Imports have also fallen (though not enough to reduce the widening trade deficit), reflecting the continued decline in commodity-related revenues, depreciated domestic currencies and subdued investment activity. This led to a decline in Africa's merchandise imports in recent years, from \$642.2 billion in 2014 to \$500.8 billion in 2016. Exports, however, contracted significantly more than imports over the period, which contributed to the region's widening trade deficit. Africa's trade balance moved from a surplus of \$24.0 billion in 2012, to a deficit of \$86.9 billion in 2014 and \$154.9 billion in 2016.

17. However, the share of manufactured goods in Africa's total exports has remained relatively stable over time, from 24.3 per cent in 1996, to 26.7 per cent in 2016. Figure VII shows that intra-African exports are relatively more diversified and industrialized than exports to the rest of the world, and therefore offer a great opportunity for industrial upgrading. This indicates that there is need for further diversification and structural transformation to better support the continent's industrialization through trade.

⁶ UNCTADStat database. Available at <http://unctadstat.unctad.org/EN/>.

Figure VII
Africa's merchandise exports and imports, product shares (percentage), 2016



Source: ECA calculations based on UNCTAD, 2017.

18. Africa's export of services also fell from \$105.8 billion in 2014, to \$101.4 billion in 2015 and further to \$95.7 billion in 2016. Africa's export of services continues to be dominated by travel, transport and other business services, which accounted for 35.3 per cent, 26.4 per cent and 14.2 per cent, respectively.

A. The African Continental Free Trade Area makes significant headway

19. The 25th Ordinary Session of the African Union Assembly of Heads of State and Government took place on 15 June 2015 in Johannesburg, South Africa. That session marked the beginning of the negotiation process on the agreement establishing the African Continental Free Trade Area. It was also a significant step towards achieving regional integration and the development agendas. It was the intention that, once established, an agreement on the African Continental Free Trade Area would go

beyond a traditional trade agreement of tariff reductions to include services, competition and intellectual property. Phase one of the negotiations was to focus on goods and services, the second phase on competition and intellectual property rights. At the time of writing the present report, major progress had been made towards concluding the first phase of the negotiations.

20. The African Union Commission, with the technical assistance of ECA, developed a draft template agreement drawing on existing legal instruments and approaches across Africa. This agreement has been refined and amended by a series of negotiating forums such as the Sixth Meeting of the Continental Free Trade Area Negotiating Forum (Niamey, 5–10 June 2017), followed by the third meeting of African Ministers of Trade (Niamey, 15 and 16 June 2017), which adopted African Continental Free Trade Area modalities for goods and services. These modalities are to form a framework that will determine the shape, structure and ambition of the Free Trade Area and provide the backbone for final market access and the schedule of commitments for trade in services. The current draft agreement includes trade remedy provisions, special and differential treatment for least developed countries, infant industry provisions, and a commitment to address non-tariff barriers and cooperation on technical barriers to trade and on sanitary and phytosanitary measures. The third meeting of African Ministers of Trade directed the African Union Commission, working with ECA and the United Nations Conference on Trade and Development, to undertake studies to determine the criteria for designating sensitive products and exclusion lists.

21. The Seventh and Eighth Negotiating Forums developed outcomes that were deliberated on during the fourth meeting of African Ministers of Trade in December 2017. That meeting approved the framework agreement of the African Continental Free Trade Area, which established the governance structures and other institutional arrangements, and the protocol on trade in services. The meeting tasked the Sixth Negotiating Forum to complete the remaining work on trade in goods and on dispute settlement by March 2018. The Ninth Negotiating Forum (Addis Ababa, February 2018) and the Tenth Negotiating Forum (Kigali, March 2018) concluded the protocol on dispute settlement and finalized unresolved issues in the Protocols on Trade in Goods and Services. At the 10th Extraordinary African Union Summit (Kigali, 21 March 2018), 50 African countries signed either the African Continental Free Trade Area agreement or the Kigali Declaration, underscoring their commitment to sign the agreement once the required review processes at the national level had taken place. Of those 50 African countries, 44 have signed the agreement.

B. Vast resources required to finance Africa's development

22. To finance the implementation of the 2030 Agenda and Agenda 2063, African countries will require the investment of immense financial resources. For Africa to meet Goal 1 of the Sustainable Development Goals alone, that is, ending the extreme poverty in the continent by 2030, it is estimated that the region requires an investment-to-GDP ratio and a financing gap-to-GDP ratio of 87.5 and 65.6 per cent per annum, respectively, between 2015 and 2030.⁷ Estimates by various sources also indicate that the required investment to finance the Sustainable Development Goals in Africa could amount to between \$600 billion and \$1.2 trillion per year, with

⁷ Abbi Kadir and others, Growth and development finance required for achieving Sustainable Development Goals (SDGs) in Africa, *African Development Review*, vol. 29, No. S1, 2017, pp. 15–26.

infrastructure alone costing \$93 billion.⁸ The decline in recent years in the revenues of the region from exports of commodities further widens the financing gap.⁹

23. Tax revenue remains the main source of domestic finance in Africa. However, it has been on a declining trend in recent years, particularly since 2013, as it fell by \$125 billion over a three-year period, from \$561.5 billion in 2012 to \$436.8 billion in 2015. This was mainly due to falling resource revenues as a result of the decline in commodity prices, particularly oil.¹⁰ Despite the recent disappointing trend, domestic revenue mobilization through taxation has gained increasing prominence in the policy debate of African countries, since higher reliance on domestic revenues would allow for a higher level of stability, predictability and control in the budget processes of the countries. Consequently, African Governments and pan-African institutions have been engaged in a number of tax reforms over the last decade.¹¹

24. Although savings and the development of capital markets remain weak, financial deepening, and the expansion of pension and sovereign wealth funds offer paths to increase domestic private investment in the region.¹² Curtailing illicit financial flows from the region could also provide hidden resources that may contribute to financing the development agenda of the continent. The innovative sources of finance offer the continent a range of options and opportunities, which could reduce considerably Africa's dependence on external resources and provide the requisite resources for the implementation of regional and global development agendas.

III. Positive medium-term growth prospects, risks and uncertainties

25. Growth is expected to reach 3.5 per cent in 2018 and 3.7 per cent in 2019, driven by continued prudent macroeconomic management and a strong domestic demand, underpinned by increasing public and private investment, especially in infrastructure in most countries. However, slow growth recovery in advanced and emerging economies and the tightening of financial markets in developed economies may negatively affect export demand and curtail foreign direct investment inflows to Africa. Despite public debt levels being sustainable, they remain high, calling for the need to invest funds borrowed into productive sectors to generate returns that would allow for timely repayment and enhance the growth prospects of the countries. Some countries may face debt repayment problems as they are caught in an environment of slow growth, widened fiscal deficits, weaker currencies, and lower export revenues.

26. Weather-related shocks remain a regional risk, in particular in parts of East Africa where droughts have been continuous in recent years. This would also affect power generation that, in turn, may affect productivity levels in some countries. Security or political uncertainties ahead of key elections pose risks to growth in some countries, creating uncertainties or delays in investment.

⁸ UNCTAD, *Economic Development in Africa Report 2016: Debt Dynamics and Development Finance in Africa* (Geneva, 2016).

⁹ Amadou Sy, *Mobilizing Financial Resources: Strategies to manage the commodity slump and attract investment*, Africa Growth Initiative (Global Economy and Development, Brookings Institution, Washington, D.C.).

¹⁰ AfDB, *African Economic Outlook 2017 Entrepreneurship and Industrialization* (Abidjan, 2017).

¹¹ *Tax Revenue Mobilization in Developing Countries: Issues and Challenges*, Policy Department DG External Policies (European Union, 2014).

¹² Innovative approaches to financing the SDGs in Africa (forthcoming ECA publication).

IV. Recent social developments

A. Slow pace of declining poverty rates amid high levels of inequality

27. As a consequence of Africa's good economic performance since 2000, the poverty headcount ratio declined from 55.6 per cent in 2002 to 41 per cent in 2013, though at a relatively slow pace of poverty reduction.¹³ Factors contributing to that situation include high poverty gaps, inequality and lack of decent job creation. The poverty gap ratio in Africa stood at 15.2 per cent in 2013, which is almost double the global average of 8.8 per cent, further slowing down the impacts of poverty reduction programmes.¹⁴ However, it is important to note that, at a disaggregated level, poverty in Africa remains a rural phenomenon, more than an urban one, yet the pace of reduction in poverty in rural areas is faster than in urban areas. This could be due to the positive role of non-farm activities in rural towns and a positive employment effect of the non-employed poor.¹⁵

28. Africa is the region with the second highest level of income inequality (expressed as Gini coefficient) at 0.44, harbouring seven of the ten most unequal countries globally. This stems the poverty reducing effect of economic growth, since a highly unequal distribution reflects a polarized economy, a narrow production base and inadequate linkages between the production base and the rest of the economy. The high levels of income inequality in Africa, south of the Sahara, are partly driven by structural features such as the stage of development, the low share of the working age population to total population and gender inequality.¹⁶

29. Despite near gender parity being achieved in primary school enrolment, gender discrimination is still evident in secondary and tertiary education. Gender inequality in social services translates into lower opportunities for the well-being of women in particular, and society in general. Indeed, African Governments while being aware of the factors impacting the status of women, do not translate gender status into budget allocations and fall short of the targets set by the African Union for spending on the social sector.¹⁷

30. As indicated above, one of the factors contributing to the slow pace of poverty reduction in African economies is the lack of decent jobs. The dependence on and exportation of primary commodities by African economies have intensified social inequalities. The slow pace of structural transformation, for example, the capital intensity of mining, has led to less employment creation and also constrained poverty reduction efforts, reaffirming the unequal distribution of income. Indeed, the share of people in vulnerable employment is still unacceptably high and heavily skewed towards young people and women.¹⁸ Poverty levels of young working people have been consistently higher than the adult working population, making them much more likely to migrate as they show discontent or seek alternative means of survival.

¹³ United Nations, *Sustainable Development Goal Report* (New York, 2017).

¹⁴ ECA, *The Sustainable Development Report: tracking progress on Agenda 2063 and the SDGs* (Addis Ababa, 2017).

¹⁵ Peter Lanjouw and Rinku Murgai (2009), "Poverty decline, agricultural wages, and nonfarm employment in rural India: 1983–2004", *Agricultural Economics*, vol. 40, No. 2, pp. 243–263.

¹⁶ D. Hakura and others, *Inequality, gender gaps and economic growth: comparative evidence for Sub-Saharan Africa*, IMF Working Paper Series, no. WP/16/111 (IMF, Washington, D.C., 2016).

¹⁷ UNDP, *Africa Human Development Report 2016: Accelerating Gender Equality and Women's Empowerment in Africa* (New York, 2016).

¹⁸ ILO, *World Employment Social Outlook: Trends* (Geneva, 2016).

B. Progress despite inadequate social outcomes

31. There has been significant progress in both education and health, yet access inequities for women, rural dwellers and low-income groups remain an important feature of the inequalities in opportunities across the continent. Primary school enrolment, for example, increased significantly from 62 million in 1990 to 149 million in 2012.¹⁹ In terms of years of schooling, however, women received on average 4.3 years while men averaged 5.7 years.²⁰

32. In health, there have been significant gains in child and maternal mortality, with maternal mortality rates dropping by 35 per cent in 2000–2015 and adolescent birth rates declining by 21 per cent over the same period.²¹ However, average improvements mask inequities of social outcomes with, for example, total fertility rates of the poorest quintile showing 6.5 children per woman, while for the richest quintile it was 3.6 children per woman.²² The combination of slow poverty reduction, consistent inequalities and vulnerable employment manifests as inadequate social outcomes in Africa.

C. Relatively high private and public expenditures but with minimal impact

33. In Africa, the size of public expenditure in relation to gross domestic product is comparable to the Organization for Economic Cooperation and Development (OECD) public expenditure levels, but with much less effect on education and health outcomes. The data available reveal that public expenditure increased between 2000 and 2012 across all subregions in Africa, despite masking variations across the subregions, with East, North and Southern Africa posting 27, 33 and 36 per cent, respectively, while in West Africa the average is just above 20 per cent (figure VIII). Public spending in OECD countries varied between less than 30 per cent of gross domestic product in the Republic of Ireland to 56 per cent in France and Finland in 2012.²³ In East Asia, public expenditure is much less, at 21.6 per cent of GDP.²⁴

34. The largest proportion of private funding for education is generated from individual households in Africa. Based on studies of 16 countries (where data were available), households contribute about 25 per cent of the total national education expenditure.²⁵

35. In a sample of 46 African countries, based on data availability, over the period 2000–2009, the number of countries with private spending as a percentage of total health expenditure of 50 per cent and above, decreased from 29 to 23 per cent, while over 70 per cent of private expenditure on health came from household out-of-pocket payments in 32 countries.²⁶

¹⁹ ECA, *Assessing Progress towards the MDGs in Africa* (Addis Ababa, 2015).

²⁰ AfDB, *African Development Report 2015. Growth, Poverty and Inequality Nexus: Overcoming barriers to sustainable development* (Abidjan, Côte d'Ivoire, 2015).

²¹ ECA, *Agenda 2063/SDGs Progress Report 2017. Assessing Africa's Domestication and Implementation of Agenda 2063 and the SDGs* (Addis Ababa, 2017).

²² ECA, *African women's report: securing Women's rights to social protection in Africa*, Working paper (Addis Ababa, 2017).

²³ OECD, *Public expenditure database* (Paris, 2016).

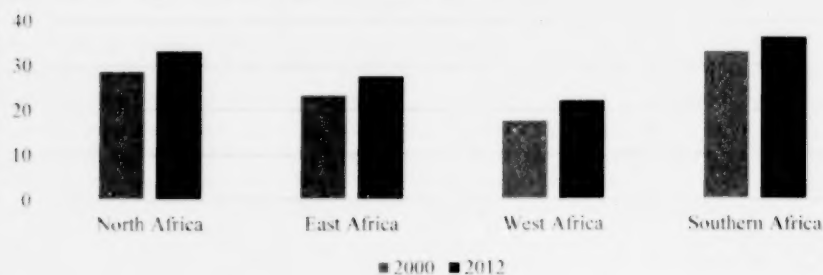
²⁴ World Bank and others *UHC in Africa: A Framework for Action*, (Washington, D.C., 2016).

²⁵ UNESCO, *Financing Education in Sub-Saharan Africa Meeting the Challenges of Expansion, Equity and Quality* (Paris, 2011).

²⁶ L. G. Sambo, J. M. Kirigia and J. N. Orem, "Health financing in the African Region: 2000–2009 data analysis", *Int. Arch. Med.*, vol. 6, No. 1, p. 10.

36. Notwithstanding the above data, constraints of private spending and the predominant role of the public sector in the provision of education and health services, private spending remains crucial for reviewing Africa's performance in relation to the spending targets relevant to the Millennium Development Goals.

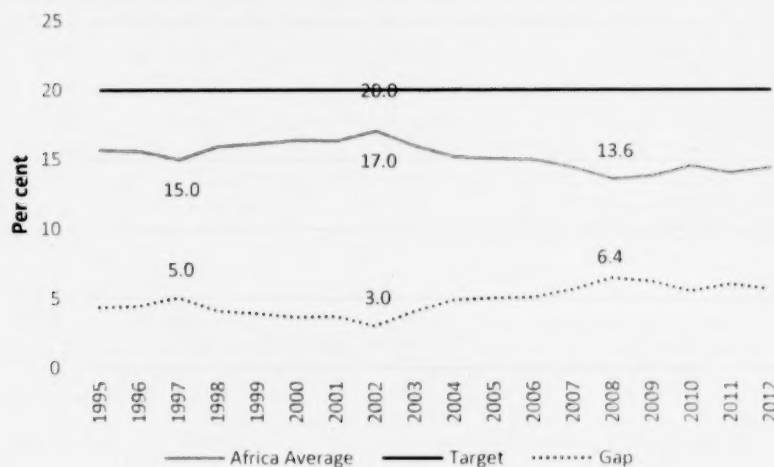
Figure VIII

Public expenditure to GDP ratio in Africa (2000–2012)

Source: International Food Policy Research Institute database (2016).²⁷

37. On average, the expenditure on education of African countries has remained close to, achieved or surpassed the 20 per cent target set, over the period 1995–2012, despite variations across countries (figure IX). Countries such as Botswana, Kenya, Namibia, Swaziland and Tunisia surpassed the target for the period 2010–2012. However, it is important to note that some countries were able to meet the stipulated target before it was set, raising questions as to whether the progress achieved in outcomes in education require an adherence to the spending targets currently set.

Figure IX

Expenditure of African countries on education as a share of government expenditure, 1995–2012

Source: Authors computations based on data from the World Bank (2017).

²⁷ International Food Policy Research Institute database (Washington, D.C., 2016).

38. In terms of health, the African Union set a health spending target of 15 per cent of government expenditure in 2001,²⁸ which was concomitant with the introduction of the Millennium Development Goals in 2000. This was also at a time when the HIV/AIDs pandemic was taking centre stage in health spending and outcomes on the continent.²⁹ Figure X shows that, although the gap in the spending target for health is much larger than that of education, on average, there seems to be an increase in health spending in Africa. Indeed, according to World Bank data, between 2001 and 2006, average health spending increased from 9.1 per cent of total government expenditure to 10.7 per cent. Between 2002 and 2004, countries such as Malawi, Rwanda, Sierra Leone and the United Republic of Tanzania increased their health spending by approximately 3 to 4 percentage points of government expenditure.³⁰ Consequently, the increase in health spending has contributed to improved outcomes in maternal and under five mortality rates in Malawi, Rwanda, Sierra Leone and the United Republic of Tanzania by approximately 1–2 per cent over the period.³¹

39. Possibly due to the cost-sharing scheme with households in most African countries, the increase in health spending has not resulted in commensurate health outcomes. Based on available data, between 2000 and 2009, there was a drop in only six countries (out of 46), where household spending on health was more than 50 per cent of total health spending. Indeed, the out-of-pocket payments have increased in nearly all African countries from \$15 per capita in 1995 to \$38 in 2014.³² In most African countries, expenditure on health is jeopardizing household welfare by putting pressure on the disposable income within households and lowering material living standards.^{33,34} The widespread private financing of health among African households “crowds out” public health allocation, in addition to which there are no socioeconomic incentives to reach the health targets set.

²⁸ African Union, Abuja Declaration on HIV/Aids, Tuberculosis and Other Infectious Diseases (Addis Ababa, 2002). Available at http://www.un.org/ga/aids/pdf/abuja_declaration.pdf.

²⁹ ECA, *Scoring African Leadership for Better Health* (Addis Ababa, 2004).

³⁰ World Bank, Japan International Cooperation Agency, Global Fund, AfDB and WHO, *UHC in Africa: A Framework for Action* (World Bank, Washington, D.C., 2016).

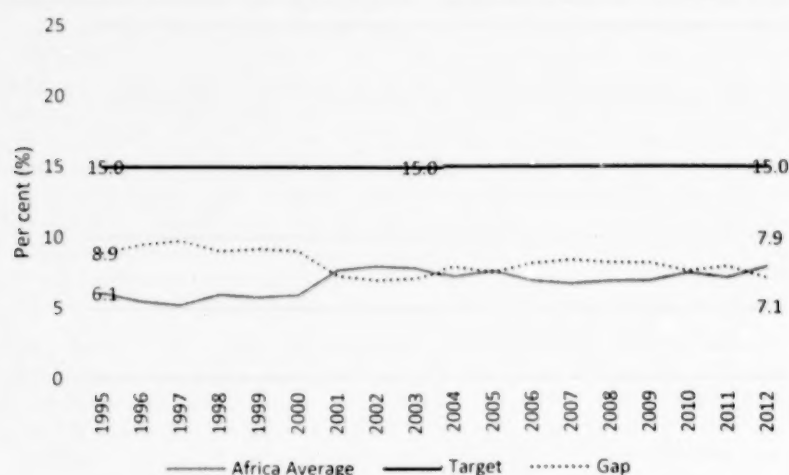
³¹ United Nations, Addis Ababa Action Agenda of the Third International Conference on Financing for Development (New York, 2015).

³² World Bank and others, *UHC in Africa: A Framework for Action* (Washington, D.C., 2016).

³³ L. Sene and M. Cisse, Catastrophic out-of-pocket payments for health and poverty nexus: evidence from Senegal, *Int. J. Health Economics and Management*, vol. 15, No. 3, pp. 307–328.

³⁴ O. Akinkugbe and others, Health financing and catastrophic payments for health care: evidence from household-level survey data in Botswana and Lesotho, *African Development Review*, vol. 24, No. 4, pp. 358–370.

Figure X
Africa health expenditure as a share of government expenditure 1995–2012



Source: ECA calculations based on data from the World Bank (2016).

40. From observation, universal health coverage has not gained the same level of political commitment as education, although it has featured prominently, starting with the 1975 Alma Ata Universal Primary Health Care for All and the 2008 African Union Framework on Social Protection. Basic health care for all was identified as one of the areas that needs public intervention. The wide inequities in access to health care that exist between different socioeconomic groups, and between rural-urban areas are mostly in accessing and utilizing health services. The only health indicator showing equality in terms of income and rural-urban differences is immunization, probably due to its universal coverage and close monitoring by national governments and donor agencies.³⁵

V. Conclusions and policy implications

41. After a sharp drop to 1.7 per cent in 2016, economic growth rose to 3 per cent in 2017, due to a slight increase in commodity prices, increased investment, especially in infrastructure, and strong growth in domestic demand. Oil-importing countries led the continent's growth among economic groupings, reflecting the move towards more diversification and an increase in public investment, especially in infrastructure. Improved macroeconomic management through fiscal consolidation and prudent monetary strategies also guided government expenditures and maintained economic stability in most countries.

42. Recent developments in the global economy demonstrate that the dependence of Africa on commodity exports is not sustainable, hence the call for diversification in African economies and the enhancement in efforts to foster value addition through industrialization and structural transformation of the economies. In order to achieve the Sustainable Development Goals, Africa's domestic demand needs to be further strengthened. Spending on infrastructure must be accelerated and increased through enhancing tax administration, fighting illicit capital outflows, tapping excess liquidity

³⁵ ECA, *Mainstreaming health equity in development planning* (Addis Ababa, 2009).

in the banking sector, and utilizing remittances and other sources of finance for development. Those processes would help in mitigating fiscal deficits.

43. The domestication of the Sustainable Development Goals in national plans and visions needs to be mainstreamed in national expenditure frameworks and budgets. The new targets and indicators should inform the national composition of specific social spending to ensure that adequate resources are allocated so that all intended objectives are met. Political commitment and leadership will be crucial in rallying resources towards a specific objective. In order to achieve the intended objectives in essential health for all, the decrease in cost sharing and out-of-pocket payments is a necessary policy intervention to avoid reducing disposable incomes and lowering living standards.

44. A positive growth outlook will depend on the countries' ability to mitigate several internal and external risks and uncertainties. Slow growth recovery in the advanced and emerging economies and the tightening of financial markets, high fiscal deficits and weather-related shocks remain a threat to the continent's medium-term growth prospects. In order to maintain and enhance the current growth prospects, African countries need to focus on medium and long-term strategies to attract private investment, and build infrastructure to boost productivity and competitiveness of their economies. Notwithstanding the challenges mentioned above, medium-term prospects for the continent remain positive.



Economic and Social Council

Distr.: General
20 April 2018

Original: English

2018 session

27 July 2017–26 July 2018

Agenda item 15

Regional cooperation

Summary of the *Economic and Social Survey of Asia and the Pacific 2018*

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith a summary of the *Economic and Social Survey of Asia and the Pacific 2018*.

18-06391 (E) 030518



Please recycle



Summary of the *Economic and Social Survey of Asia and the Pacific 2018*

[Original: Chinese, English, French and Russian]

Summary

The average growth in gross domestic product of the Asia-Pacific region continues to increase steadily on the back of firmer global demand, while inflation remains stable. The key tasks at hand are to ensure that such economic performance is sustained over time, that it benefits everyone, and that the environmental implications are minimal. However, financial risks and protectionist trade measures weigh on the near-term macroeconomic outlook, while the medium-term challenges of lifting the region's potential economic growth and reducing poverty on a sustained basis continue. Furthermore, while rapid technological advancements promise immense opportunities, they also pose considerable challenges in terms of job polarization as well as income and wealth inequalities. The pursuit by China of innovative, inclusive and sustainable economic growth could also have important regional impacts through trade, investment and other channels.

Member States are advised to make the most of current favourable economic conditions to enhance the resilience, inclusiveness and sustainability of economic growth.

The implementation of several policy initiatives needed for these objectives will require not only the channelling of existing financial resources, from both the public and the private sectors, towards sustainable development, but also additional financial means. The *Economic and Social Survey of Asia and the Pacific 2018* contains an examination of how Governments of countries in the Asia-Pacific region could increase domestic public financial resources and leverage private capital to strengthen the long-term prospect of economies. Complementing the analyses contained in previous issues of the *Survey*, it contains illustrative estimates of how much additional finance countries may be able to mobilize from such measures as reforms in tax administration and tax incentives, the introduction of carbon taxes, prudent sovereign borrowing from financial markets, and an enabling environment for public-private partnerships.

The Commission may wish to take note of the key messages and findings of the 2018 *Survey* as contained in the present document. The Commission is invited to consider the issues analysed, along with policy suggestions, and provide the secretariat with guidance for its future work on mobilizing development finance to enhance the prospect of achieving sustained, inclusive and sustainable economic growth.

Contents

	<i>Page</i>
I. Introduction	4
II. Economic performance and outlook	5
III. Macroeconomic risks and medium-term challenges to economic outlook	9
IV. Economic policies for sustained, inclusive and sustainable economic growth	11
V. Mobilizing financing for sustained, inclusive and sustainable economic growth	13
VI. Concluding remarks	19

1. Introduction

1. Sustainable Development Goal 8 calls for the promotion of sustained, inclusive and sustainable economic growth. These three aspects of economic growth correspond to the three dimensions of sustainable development: economic resilience, social inclusiveness and environment sustainability. The well-being of societies increases if progress is made on all three fronts. In the *Economic and Social Survey of Asia and the Pacific 2018*, these issues are analysed and policy options that can help countries to effectively pursue these objectives are discussed.

2. Building on the assessments in previous issues — inter alia, on making growth inclusive (2015), nurturing productivity (2016) and enhancing governance and fiscal management (2017) — the 2018 *Survey* contains an exploration of the importance of financing for development and an examination of how the Governments of Asia-Pacific countries could increase domestic public financial resources and leverage private capital to strengthen the long-term prospect of economies.

3. According to that assessment, average growth in gross domestic product (GDP) in the developing economies of the Asia-Pacific region continues to improve steadily while inflation remains stable. However, protectionist trade measures and financial risks weigh on the near-term macroeconomic outlook while various medium-term challenges include low productivity and inadequate growth of decent jobs, against the backdrop of demographic transitions and new technologies. Reducing poverty on a sustained basis, mitigating inequality, and internalizing environmental costs and climate risks are other challenges that the region faces.

4. In view of such challenges, the 2018 *Survey* contains advice to Governments to consider the following policy measures:

(a) Monetary and financial policy should focus on supporting a smooth transition to the pickup in inflation and financial tightening prompted by stronger global growth while tackling systemic risks in the financial system through appropriate macroprudential measures. The latter are important in view of high private debt and distressed bank loans that are constraining robust investment;

(b) Fiscal policy should be focused on supporting the medium-term objectives of lifting productivity growth and reducing inequalities as the need for near-term stimulus diminishes. Beyond allocating more resources to education, health, social protection and infrastructure, greater progress is needed to enhance expenditure efficiency and ensure equal access to public services. Progressive taxation could help increase fiscal space;

(c) While there are sector-specific ways to improve expenditure efficiency, a cross-cutting factor is good governance. One of the ways in which Governments could improve fiscal governance is by leveraging technology; for instance, countries that proactively use e-government tools tend to perform better in terms of corruption perception;

(d) Parallel efforts are needed to foster innovation and ensure that the benefits are widely shared. Leading innovative countries take a whole-of-government approach and invest in the relevant skills and infrastructure, but efforts are needed to leave no country behind. Competition policy, labour market policy and fiscal policy should be calibrated to support inclusive innovation. Universal basic income could be considered as well;

(e) Without improving the quality of economic growth, economic resilience, too, will be compromised. Governments should strengthen social protection as a strategic way of enhancing economic resilience and economic dynamism, not least in

view of demographic transitions (risk of skills shortage among youth on the one hand, and risk of old-age poverty on the other) and labour market disruptions associated with reforms and technological innovations;

(f) At the same time, Governments should mainstream resource-efficiency targets into national plans and budgets as well as into sectoral policies, and establish appropriate legal and regulatory measures to enforce standards and to promote awareness. Carbon tax and emissions trading systems could play a critical role in transitioning to a low-carbon, climate-resilient economy.

5. Given the comprehensive nature of the 2030 Agenda for Sustainable Development, there is considerable need to step up investments to achieve the Sustainable Development Goals. Thus, the 2018 *Survey* examines how countries could mobilize development finance by focusing on three areas:

(a) Strengthening of tax revenues, primarily by improving tax administration, rationalizing existing tax incentives and introducing new tax instruments; through various quantitative exercises, the 2018 *Survey* demonstrates that the potential impact of these policy changes on tax revenue is substantial, and the success of these policy changes would be greatly enhanced by regional cooperation and integration;

(b) Prudent sovereign borrowing from financial markets: public debt sustainability analysis suggests that many Asia-Pacific economies could afford higher public debt, which would be appropriate insofar as it focuses on public goods and services that enhance the supply side of the economy and make it more efficient, inclusive and sustainable; to increase the role of public bond issuance in enhancing public finances, maintaining an effective institutional framework is important;

(c) Leveraging of private capital, primarily by enhancing a policy environment where public-private partnerships are a viable option, to increase investments in sustainable infrastructure.

6. The document is structured as follows. Section II contains an updated assessment of the economic performance and outlook of the Asia-Pacific region. In section III, macroeconomic risks and medium-term challenges are discussed. In section IV, the policies needed for sustained, inclusive and sustainable economic growth are analysed, while in section V the financing for development aspects that can support the range of policy options are delved into. Section VI contains concluding remarks.

II. Economic performance and outlook

A. Global context: stronger growth and associated challenges

7. In 2017, there was a broad-based recovery in global manufacturing, investment and trade, resulting in the fastest output expansion in five years. The upturn was evident in the United States of America, the euro area and Japan, along with continued strong performance in China and gradual recovery in major commodity exporters. This momentum is expected to be largely sustained. Global output is projected to grow by 3 per cent and 3.1 per cent in 2018 and 2019 respectively, on a par with an estimated 3 per cent in 2017.¹ Global trade volumes, which rebound in 2017, are expected to moderate only slightly in the forecast period.

¹ International Bank for Reconstruction and Development/World Bank, *Global Economic Prospects: Broad-based Upturn, but for How Long?* (Washington, D.C., 2018). Available from www.worldbank.org/en/publication/global-economic-prospects

8. This upturn, however, comes after an extended period of weak investment and low productivity growth; making up for it will take time.² The belated but stronger than anticipated recovery brings its own challenges. The expectation of a faster rise in interest rates could trigger financial market volatility, as seen recently. Global oil prices reached \$70 per barrel at the beginning of the year, from \$30 per barrel two years ago. While some easing is expected, large oil importers such as India could face higher inflation and wider current account deficits.

B. Economic growth: a broad-based upturn and stable outlook

9. Developing Asia-Pacific economies benefited from the global tailwind, growing by an estimated 5.8 per cent in 2017, compared to 5.4 per cent in 2016.³ About two thirds of the region's economies achieved faster growth in 2017. In China, strong global demand, resilient private consumption and service activities continued to drive economic growth, but investment moderated amid efforts to curb pollution and overcapacity in certain industries. In India, the recently introduced goods and services tax as well as weak corporate and bank balance sheets resulted in subdued economic growth, but signs of recovery have emerged in the second half of the year. The Russian Federation resumed growth after a two-year recession on the back of higher oil prices and more stable inflation and credit conditions. Least developed countries in the region grew by 6.8 per cent, the fastest in a decade, supported by stronger trade and investment flows, although they remain vulnerable to terms-of-trade shocks and natural disasters and face skills and infrastructure bottlenecks.⁴

10. Developing Asia-Pacific economies are projected to grow by 5.5 per cent in both 2018 and 2019, with slight moderation in China offset by a recovery in India and steady performance in the rest of the region. Recently firmed economic activities in China could provide the authorities with more room to continue deleveraging and rebalancing towards a services-and consumption-driven economy, which suggests that the region's largest economy would have steadier but slower economic growth.

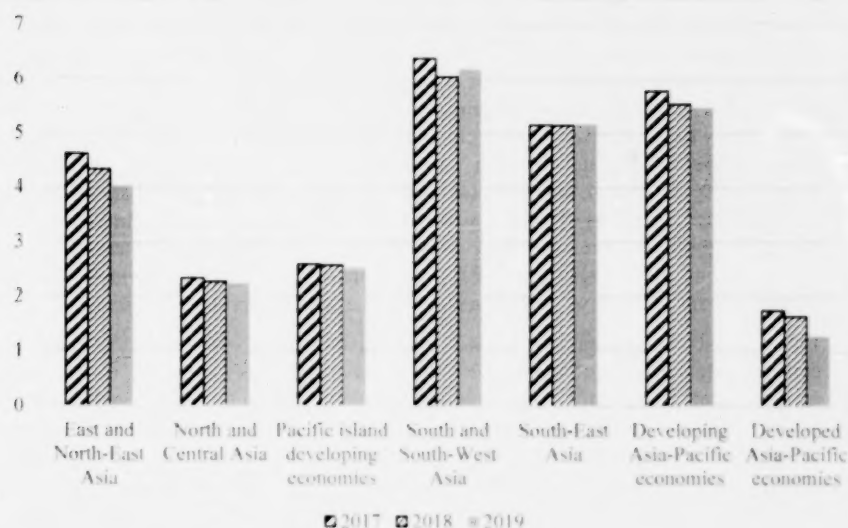
² *World Economic Situation and Prospects 2018* (United Nations publication, Sales No. E.18.II.C.2).

³ Aggregate growth rates were calculated using 2015 GDP at 2010 United States dollars as weights, a change from previous calculations using 2010 GDP at 2010 prices. The update better reflects the current structure of economies. Largely reflecting the increase in the weight of China, the shift in the base year resulted in increased aggregate growth by approximately 0.2 percentage points compared with the previous base year.

⁴ *Asia-Pacific Countries with Special Needs Development Report 2017: Investing in Infrastructure for an Inclusive and Sustainable Future* (United Nations publication, Sales No. E.17.II.F.9).

Figure 1
Economic growth in the Asia-Pacific region

(Year-on-year percentage change)



Source: Economic and Social Commission for Asia and the Pacific (ESCAP).

Notes: Data for 2017 are estimates, and data for 2018 and 2019 are forecasts. Developed Asia-Pacific economies comprise Australia, Japan and New Zealand.

C. Inflation: picking up but still low

11. In line with higher global oil prices and strong aggregate demand, consumer price inflation in developing Asia-Pacific economies is projected to rise to 3.5 per cent in 2018 and 2019, compared with 3.2 per cent in 2017, with inflation accelerating in about 60 per cent of the countries. In China, the Republic of Korea and Japan, recovering producer prices are expected to contribute to higher consumer price inflation. However, inflation has subsided in North and Central Asia, from 7.8 per cent in 2016 to 4.5 per cent in 2017, and is expected to remain stable in the forecast period.

12. Despite some pickup, inflation remains at historically low levels. Aside from country-specific factors such as good harvest and stable food prices, there are a number of global reasons relating to commodities, currencies, capacity and technology. First, despite the agreement among member countries of the Organization of the Petroleum Exporting Countries (OPEC) plus a group of non-OPEC members to cut oil production, oil prices are not expected to rise further given the reduced cost of extracting shale oil in the United States of America (where oil output exceeded 10 million barrels per day for the first time in 48 years) and the dramatic decline in renewable energy prices. Second, currency appreciation in several economies has eased price pressures through cheaper imports. Third, economies may still be operating below potential, with slack capacity as mirrored in subdued growth in real wages and formal employment. Fourth, global value chains and e commerce may be meeting demand at lower costs, while the increased use of robots in production processes places downward pressure on wages and prices.

D. Consumption, investment and trade dynamics: strengthening the drivers of economic growth

13. In line with the region's growing purchasing power and as is visible in high consumer confidence, domestic private consumption has been the major economic growth driver in recent years. It has been supported by low inflation, low interest rates and stable labour market conditions. The recovery in remittances, especially in North and Central Asia, also supported consumption. However, consumption-led economic growth may be fragile over time without consistent increases in real wages backed by rising productivity. Such growth can lead to debt accumulation and financial vulnerability. Moreover, society's welfare depends on the inclusivity of consumption growth. Since the 1990s, the consumption share of the top quintile has increased while the other quintiles have seen their share decrease. Recent data also reveals that in nearly half of the countries in the region, consumption by the bottom 40 per cent, already substantially low, grew at a slower pace than the average household.⁵

14. Robust investment is critical for sustained income growth, on which consumption ultimately depends. However, investment performance was relatively weak in recent years amid heightened global uncertainty and weak corporate and bank balance sheets. Thus, simply lowering policy interest rates was not enough to revive investment. Over the past year, there has been a welcome recovery in investment on the back of firmer global demand and stronger trade. Public infrastructure outlays have supported investment in countries such as Indonesia and Pakistan.

15. While leading indicators such as the Purchasing Managers Index and national budget decisions are encouraging, sustained investment recovery could be undermined by protectionist trade measures, tighter financial conditions and uncertainty over the domestic legal and regulatory environment. Investment slowdowns associated with balance sheet problems tend to be more persistent and require policy support. Moreover, attention is needed to determine whether investment is effectively supporting the 2030 Agenda. Generally, the social, environmental and economic impacts of investment, including foreign direct investment (FDI), should be considered.

16. Developing Asia-Pacific economies experienced a trade recovery in 2017. Contributing factors included stronger demand in China and the global rebound in the electrical and electronics trade, which makes extensive use of regional production networks. In 2018, growth in export and import volumes is projected to moderate, to 3.5 per cent and 3 per cent respectively.⁶ The uptick in 2017 was measured against the previous year's weak performance; thus, a high base effect will kick in. Growth moderation in China could be reflected in its import demand, especially for metals and related goods.

17. Trade has contributed to the region's rapid economic growth and poverty reduction in recent decades, but has come under increased scrutiny amid rising income and wealth inequality. Trade liberalization measures, pursued in a multilateral manner, are needed. However, the debate over the benefits of trade is getting diluted in dealing with rising inequalities. Efforts are also needed to address the social and environment impacts of trade, including complementary domestic measures to help affected workers and firms through their transition.⁶

⁵ World Bank, Global Database of Shared Prosperity. Available from: www.worldbank.org/en/topic/poverty/brief/global-database-of-shared-prosperity (accessed 12 March 2018).

⁶ *Asia-Pacific Trade and Investment Report 2017: Channelling Trade and Investment into Sustainable Development* (United Nations publication, Sales No. E.17 II.F.22).

III. Macroeconomic risks and medium-term challenges to economic outlook

A. Global uncertainty, trade protectionism and financial risks

18. High policy uncertainty continues to cloud the prospects for world trade, orderly migration and climate targets, and may delay a more broad-based rebound in global investment and productivity.⁷ For trade, protectionism casts a shadow on its consistent revival. Since the global financial crisis of 2008, the use of trade-restrictive measures has risen considerably, including non-tariff measures (which are less transparent and more harmful). The rise in trade barriers may disrupt cross-border production networks, affecting trade and provoking retaliatory measures. While fears of a trade war may not be realized, rising uncertainties could preclude long-term investment and trade.⁸

19. Given the recent economic recovery in the United States of America and the euro area, faster than expected increases in interest rate cannot be ruled out. This could dampen capital flows to the Asia-Pacific region and result in asset price corrections and exchange rate volatility. A key source of financial vulnerability is the high and rising private debt in some economies, both at the corporate level, such as in China and India, and at the household level, especially in Malaysia, the Republic of Korea and Thailand. Rapid increases in private debt can affect whole financial systems, as during the Asian financial crisis.⁹

20. The combination of the weaker United States dollar and higher oil prices over the past year also poses risks. Historically, the two have shown an inverse relationship, as oil is a dollar-denominated asset. While the baseline projection is that the dollar will strengthen and that the oil price rally will subside from the levels seen at the beginning of 2018, there is considerable uncertainty over their trajectories and net impact. Dollar strength has implications for trade competitiveness but also for dollar loans and dollar-denominated debt. Oil prices have macroeconomic implications, with the effects roughly the opposite for oil exporters versus importers.⁸

B. Potential economic growth, technology and the future of work

21. In the medium term, sustained poverty reduction and improvement in living standards will require the lifting of potential economic growth, which is on a downward trend in several countries owing to population ageing, slower capital accumulation and modest productivity growth. Notably, the potential growth rate in China fell sharply from around 10 per cent during the period 2003–2007 to around 7 to 8 per cent during the period 2013–2017,⁹ with further declines projected through to 2030.¹⁰ Potential growth has declined over the past decade in India owing to a sharp slowdown in capital accumulation; recent estimates of its potential growth are within the range of 6 to 8 per cent.¹¹

⁷ *Economic and Social Survey of Asia and the Pacific 2017: Year-end Update* (SIA/SCAP/2808).

⁸ The potential impacts of higher oil prices on various macroeconomic indicators are estimated in the full *Survey*.

⁹ International Bank for Reconstruction and Development/World Bank, *Global Economic Prospects*.

¹⁰ The Development Research Centre of the State Council of China projects economic growth to moderate to 4 to 5 per cent by the period 2025–2030. The full *Survey* contains an in-depth analysis of the economic transformation of China and its implications for other countries in the region.

¹¹ Barendra Kumar Bhoi and Harendra Kumar Behera, "India's potential output revisited", *Journal of Quantitative Economics*, vol. 15, No. 1 (March 2017), pp. 101–120.

22. It is estimated that by 2050 one in every four people in the region will be aged 60 years or older. Among other implications, such a demographic transition could have a major effect on long-term economic growth. As population ageing progresses in the face of relatively low incomes in the region's economies, lifting potential growth will require higher productivity growth. Productivity growth in the developing countries of the Asia-Pacific region has been modest and has declined by more than half between the periods 2000–2007 and 2008–2014. Contributing factors include skills and infrastructure deficits, inefficient allocation of resources and weak technological innovation and diffusion. Addressing these weaknesses depends, among others, on good governance and effective institutions.¹²

23. Rapid technological advancements, while offering enormous opportunities, pose challenges as well. New technologies, such as three-dimensional printing, big data, robotization of production processes and artificial intelligence, are making rapid inroads and could induce a productivity-led economic growth spurt in the future.¹³ Similarly, fintech and e-government applications are examples of technologies that could support sustainable development. However, technology and innovation favour skilled over unskilled labour and bias capital over labour, thus contributing to inequality of income and wealth. While there are differing views on whether new technologies will displace labour and result in downward pressure on wages, job polarization is likely to increase regardless. Moreover, increased automation in developed countries and in China could reduce the scope for industrialization in other developing countries and thus the ability to expand decent jobs.

C. Impact of the economic transformation of China on Asia and the Pacific

24. The pursuit by China of innovative, inclusive and sustainable economic growth could have important regional impacts through trade, investment and other channels. If ongoing structural reforms in China are successful, total factor productivity would overtake capital formation to become the major driver of growth, and the service sector would account for 70 per cent of GDP by 2030, close to current levels in developed economies. Such changes will affect the trade structure of China.

25. As China moves up the value chain, such countries as Bangladesh and Viet Nam could enjoy greater opportunities to engage in low-skilled, labour-intensive manufacturing. Existing technology exporters could face increased competition, however. Commodity exporters could also be adversely affected in the near term. Nevertheless, the growing domestic market in China augurs well for regional trading partners in the medium term. At the same time, outbound investment by China in the region has steadily increased over the past decade. Going forward, the quality as well as the quantity of Chinese investments will be important for recipient countries' economic development and mutually beneficial trade relationships.

D. Poverty and inequality

26. The relatively high incidence of poverty and rising inequalities are adversely affecting the region's dynamism and economic outlook. Despite a considerable reduction in extreme poverty in the region, led by China, the incidence of poverty

¹² *Economic and Social Survey of Asia and the Pacific 2017: Governance and Fiscal Management* (United Nations publication, Sales No. E.17.II.F.8).

¹³ Erik Brynjolfsson and Andrew McAfee, *The Second Machine Age: Work, Progress, and Prosperity in a Time of Brilliant Technologies* (New York and London, W. W. Norton and Company, 2014).

remains relatively high in several economies, especially in South Asia and in least developed countries. Across the region, large segments of the non-poor population remain vulnerable to falling back into poverty; they could be defined as constituting a transitional class rather than a middle class.¹⁴

27. Moreover, such factors as technological progress, globalization and market-oriented reforms that have supported rapid economic growth are contributing to wider inequality of income and wealth, which does not bode well for the inclusive development of the region. The Gini coefficient on income distribution in the region increased from 32.7 for the period 1990–1994 to 38.1 for the period 2010–2014. There is also wide inequality of opportunities across urban-rural and income lines. It is increasingly being recognized that high and rising economic inequality is detrimental to sustained economic growth.

IV. Economic policies for sustained, inclusive and sustainable economic growth

A. Monetary policy and financial stability

28. In 2017, thanks to stable inflation, most countries in the region did not unwind the expansionary monetary policy stances adopted in recent years, and mostly kept the policy rates unchanged or even reduced them further as in the case of India, Indonesia, the Russian Federation and Viet Nam. Despite an overall stable inflation outlook, this trend may not continue given the recent uptick in oil prices, financial sector risks and faster than expected increases in interest rates in the United States of America and the euro area. Therefore, gradual increases in interest rates, as introduced by Malaysia and Pakistan recently, should not be ruled out.

29. The fundamental role of monetary policy in sustaining economic growth over long periods is to contribute to macroeconomic and financial stability. Central banks could step up deleveraging efforts to tackle systemic financial risks and assign high priority to strengthening macroprudential frameworks, regulation and supervision. Some countries in the region have introduced measures to curb excessive credit growth, increase asset quality and tighten mortgage rules in lending. Such measures are important in view of the high levels of private debt and distressed bank loans that are constraining robust investment.

B. Fiscal policy

30. Fiscal policy should be focused on lifting productivity growth and reducing inequalities, as the need for near-term stimulus diminishes. After widening to nearly 3 per cent of GDP in 2016, fiscal deficit has stabilized in 2017 and is expected to narrow in the forecast period on the back of stronger economic growth. Moreover, fiscal sustainability gap analysis by ESCAP suggests that government debt ratios will stabilize or decline in most countries in the baseline scenario. While these points are encouraging, greater attention is needed for the composition and quality of government expenditure. Education and health outcomes are important for labour productivity but combined education and health expenditure remains below 5 per cent of GDP in such countries as Bangladesh, Cambodia and Pakistan. There are positive examples in the region. Several countries have identified new sources of fiscal space

¹⁴ *Economic and Social Survey of Asia and the Pacific 2016: Nurturing Productivity for Inclusive Growth and Sustainable Development* (United Nations publication, Sales No. E.16.II.F.10).

to extend social protection coverage and benefits, including by reallocating part of their military expenditure or phasing out regressive energy subsidies.

31. In addition to budget reallocation, Governments could increase expenditure efficiency and ensure equal access to basic public services. Without such efforts, additional spending may not translate into better development outcomes. Estimation of public expenditure efficiency would suggest that many countries have ample room to improve. For instance, compared with regional peers at the frontier, Pakistan could decrease its public expenditure by some 33 per cent in education and 17 per cent in health to produce the same level of education and health outcomes. Similarly, it has been estimated that approximately 30 per cent of the potential benefits of public investments are lost owing to inefficiencies. While there are sector-specific ways to improve expenditure efficiency, a cross-cutting factor is good governance. One of the ways in which Governments could improve fiscal governance is by leveraging technology; for instance, countries that proactively use e-government tools tend to perform better in terms of corruption perception.

C. Structural reforms to enhance innovation and improve the quality of growth

32. Lifting productivity will require a whole-of-government approach to foster science, technology and innovation, as well as investments in relevant skills and infrastructure. At the same time, Governments can consider a wide range of redistributive measures to mitigate the risks of technology-induced inequality and unemployment. Information and communications technology infrastructure is essential for supporting innovative growth and narrowing the existing digital divide. To develop the core skills necessary for people to be flexible and responsive to the rapid changes that are brought about by new technologies, more students, especially female students, should be encouraged to take courses related to science, technology, engineering and mathematics.

33. At the same time, to mitigate the potential adverse impacts on income distribution, Governments can consider progressive income taxes and wealth-related taxes. A more radical proposal is the universal basic income, whereby every individual receives an unconditional cash grant. A basic calculation suggests that the fiscal cost of the universal basic income (targeted at providing \$1.90 per day for the working-age population) in the Asia-Pacific region could be approximately 14 per cent of GDP on average.

34. Without improving the quality of growth, economic resilience, too, will be compromised. Governments could strengthen social protection as a strategic way of enhancing economic resilience, not least in view of the demographic transitions (risk of skills shortage among youth on the one hand, and risk of old-age poverty on the other) and labour market disruptions associated with reforms and technological innovations. At the same time, Governments could mainstream resource-efficiency targets into national plans and budgets as well as into sectoral policies, and establish appropriate legal and regulatory measures to enforce standards and to promote awareness. Carbon tax and emissions trading systems could play a critical role in transitioning to a low-carbon, climate-resilient economy.

V. Mobilizing financing for sustained, inclusive and sustainable economic growth

A. Potential policy options to mobilize development finance

35. The implementation of several policy measures, discussed above, will require not only the channelling of existing financial resources, from both the public and the private sectors, towards sustainable development, but also additional financial means. A recent estimate shows that low and lower-middle-income countries need, on average, an additional \$1.4 trillion per year, or about 11.5 per cent of their combined GDP, during the period 2015–2030 to achieve the Sustainable Development Goals.¹⁵ For all developing countries worldwide, it has been estimated that such additional investment requirements increase to \$2.5 trillion per year during the same period.¹⁶ For infrastructure only, ESCAP estimated that annual infrastructure investment needs in least developed countries, landlocked developing countries and small island developing States in the Asia-Pacific region are about 10.5 per cent of GDP on average during the period 2016–2030.¹⁷ Such needs far exceed current infrastructure spending of 4 to 7.5 per cent of GDP in those economies.

36. While these estimates are all indicative and not generally comparable, they all point to a need for a considerable boost to future investments to make economies resilient, inclusive and sustainable. The good news is that ample financial resources and savings, mostly in the private sector, are available in the Asia-Pacific region. For instance, the combined value of international reserves, market capitalization of listed companies and assets being held by financial institutions, insurance companies and various funds in developing Asia-Pacific economies is estimated at about \$56.2 trillion. Part of these private sector resources could potentially be mobilized for sustainable development. For example, the 2018 *Survey* shows that an appropriate policy environment could increase investments made by institutional investors in long-term infrastructure projects. Similarly, listed firms and commercial banks could directly support social inclusiveness and environmental sustainability through such initiatives as impact investment and corporate social responsibility.

37. Governments should lead the way to enhance needed investments and facilitate the leveraging of private capital. A multipronged strategy should be considered. First, efficient use should be made of available fiscal resources through effective expenditure management so that greater development impacts could be attained for the same amount of fiscal resources. Improving governance is the key in this regard. Second, the fiscal space should be enhanced through greater efforts to boost revenues and borrowings from the financial markets in a responsible manner. Third, the Sustainable Development Goals should be used to provide guidance for future private investments and identify areas where public resources are likely to flow and demand is likely to increase. Fourth, public financing should be used as a catalyst to attract private resources rather than replace private financing; initial public outlays pave the way for additional private investments. Fifth, appropriate regulations and institutional frameworks that would shape the space for private investments should be developed. Sixth, better indicators of systemic risk (risks associated with poor governance, weak contract enforcement and vulnerability to instability) that would capture progress on economic as well as social and environmental fronts should be developed.

¹⁵ Guido Schmidt-Traub, "Investment needs to achieve the Sustainable Development Goals: understanding the billions and trillions", 12 November 2015. Available from www.unsd.org/wp-content/uploads/2015/09/151112-SDG-Financing-Needs.pdf.

¹⁶ *World Investment Report 2014: Investing in the SDGs — An Action Plan* (United Nations publication, Sales No. E.14.II.D.1).

¹⁷ *Asia-Pacific Countries with Special Needs Development Report 2017*.

Government policies and public investments, such as those aimed at improving the judicial system, enhancing the productivity of the population and setting up effective natural disaster prevention, are de-risking; they should be taken into account when considering investments in the development endeavours of developing countries.

38. Building on previous work, the 2018 *Survey* focuses on three areas: (a) strengthening tax revenue collection by improving tax administration and expanding the tax base; (b) prudent sovereign borrowing from financial markets; and (c) effective leveraging of private capital, including by enhancing a policy environment for public-private partnerships and increasing the private sector's investments in sustainable development. These three areas are highlighted in greater detail below.

B. Strengthening of tax revenue collection

39. Recent issues of the *Survey* have highlighted the need for Governments to steer the economic growth strategies of their economies. The role of strong fiscal positions is paramount in this endeavour. For instance, in the 2014 *Survey*, the tax potential in Asia-Pacific economies was estimated, based on each country's economic structure. Actual tax collection levels were shown to be below the potential levels in 17 economies with available data. Among other policy recommendations in the report, it was emphasized that there was a need to (a) enhance tax administration by streamlining procedures and increasing the use of information technology, and (b) expand the tax base by rationalizing existing tax exemptions and introducing new taxes. Against this background, in the 2018 *Survey* the analysis is expanded by examining the extent to which recommended tax policies, if implemented, would help narrow the gap.

40. Better tax administration helps enhance revenue collection efficiency by reducing tax avoidance and evasion, including by influencing people's willingness to pay taxes (tax morale). Literature on optimal taxation usually assumes that the capacity to implement complex tax schemes, including exemptions, exists and that tax morale is not an issue. However, in practice, that is not often the case in many developing countries, such as in South and South-West Asia. Tax systems need to be simple, transparent, progressive and fast.

41. The quality of tax administration depends on factors such as the institutional set-up of tax authorities or the legal and regulatory framework in which they operate. Measures such as adopting a risk-based compliance control, training tax officials and consulting with relevant stakeholders can help improve tax administration. Some indicators of good tax administration include low cost-to-collection ratio, high actual-to-target tax revenue ratio and speedy tax services. In addition to higher tax revenue, better tax administration has economic benefits such as narrower productivity gaps between small and large firms because smaller companies typically face higher tax compliance costs.

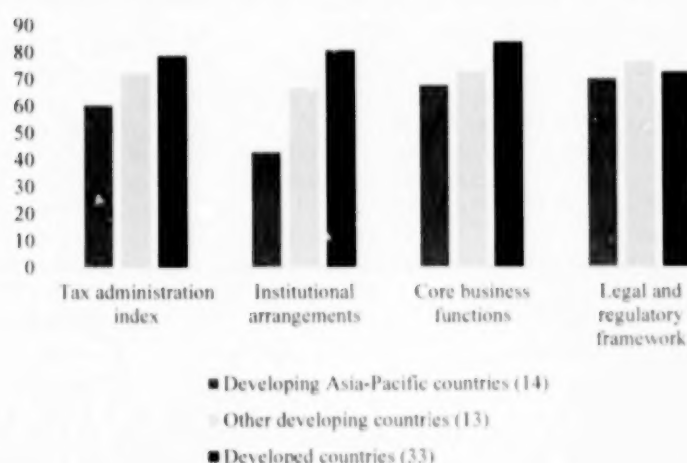
42. In the 2018 *Survey*, a new composite index is proposed to measure the extent to which the institutional setting and policy environment enable tax authorities to address tax avoidance and evasion, thus enhancing revenue collection efficiency. The tax administration index comprises three equally weighted sub-indices: (a) institutional arrangements that grant autonomy to tax authorities to, among others, design internal structure and exercise discretion over operating expenditure; (b) core business functions that manage compliance risk, such as the operation of a large taxpayer unit and the use of information technology; and (c) a legal and regulatory framework that enables tax administrations to obtain information on taxpayers' liabilities and to promote private sector development. The new index, which is

primarily drawn from survey-based information of tax authorities, is available for 60 economies, of which 14 are developing Asia-Pacific economies.

43. According to the tax administration index, the quality of tax administration in developing Asia-Pacific economies appears worse than that in developed countries and in developing countries in other world's regions with available data (figure II). The region lags behind in all three sub-indices of the tax administration index.

Figure II

Tax administration index in developing Asia-Pacific economies and beyond



Source: ESCAP analysts.

Note: The numbers in parentheses indicate the number of countries with available data.

44. Countries with better quality of tax administration exhibit stronger tax collection capacity. In the 2018 *Survey*'s explanation of the level of tax-revenue-to-GDP ratio across countries, the impact of the Tax Administration Index is estimated to be significant. A one-point increase in the index value is associated with an increase in tax revenue of 0.15 per cent of GDP. If the values of the Tax Administration Index in individual Asia-Pacific economies are assumed to match the average level being observed in member countries of the Organization for Economic Cooperation and Development, the potential revenue impact could be as high as 8 per cent of GDP in countries such as Myanmar and Tajikistan, and approximately 3 to 4 per cent of GDP in larger countries such as China, India and Indonesia.

45. Apart from improving tax administration, rationalizing existing tax incentives is another policy option to enhance public finances. In this regard, most countries in the region offer various types of tax incentives to attract FDI. In some countries, tax incentives are offered to compensate for deficiencies in infrastructure, burdensome regulatory framework and lack of political stability. In other cases, tax incentives are provided in response to a race among regional economies to offer more generous benefits to foreign investors.

46. In the 2018 *Survey*, the size of tax expenditure relating to FDI tax incentives in developing Asia-Pacific economies is estimated. The revenue forgone is the difference between actual tax payments and tax liabilities under a hypothetical case in which FDI tax incentives are absent, so the statutory corporate income tax rate is applied to profit. While this approach does not take into consideration possible changes in firms' investment decisions due to changes in tax incentives, the estimate

could still indicate the order of magnitude of tax revenues available if Governments wish to rationalize FDI tax incentives. On the basis of firm-level financial data of over 28,500 registered foreign companies in nine developing Asia-Pacific economies, the total tax expenditure related to FDI incentives is estimated at close to \$16 billion in 2014.¹⁸ These economies are some of the major FDI destinations in the region. In some cases, the size of tax revenue forgone is up to 0.3 per cent of GDP.

47. In the 2018 *Survey*, it is emphasized that, while there is a need to rationalize FDI tax incentives, a policy priority is improving investment climate by, for example, offering a business-friendly regulatory framework and decent infrastructure. At the regional level, greater regional cooperation could help to avoid a race among regional economies to offer more generous FDI tax benefits.

48. In the context of expanding the tax base, the 2018 *Survey* also contains an estimate of the size of tax revenue that a carbon tax could generate. By considering a country's level of carbon emissions, the tax rate of carbon-pricing initiatives in developing countries worldwide and the extent to which introduction of a carbon tax could reduce tax revenues from other sources, it is shown in the 2018 *Survey* that the potential revenue of a carbon tax in the region is significant. As a whole, a carbon tax could generate approximately \$43.3 billion additional tax revenue per year in 38 developing Asia-Pacific economies. On average, the estimated increase in the total tax revenue is equivalent to 0.16 per cent of GDP, and increases to 0.21 per cent of GDP in a group of countries with higher carbon intensity, including Mongolia, Turkmenistan and Uzbekistan.

49. When the introduction of a carbon tax is being considered, one key implementation issue is its impact on income distribution. A carbon tax is generally regressive, as poorer households spend disproportionately more on electricity service, whose tariff may increase with a carbon tax. In this regard, Governments could consider reducing taxes in other areas to compensate for higher energy prices. The Government could also make the introduction of a carbon tax revenue-neutral in the short term by spending carbon tax revenue on schemes that promote the development of green technologies.

C. Prudent sovereign borrowing from financial markets

50. Balancing the developmental role of fiscal policy with fiscal sustainability is a contentious issue. While public debt sustainability should be closely monitored and maintained, Governments should also ensure that meeting targeted fiscal outcomes and predetermined fiscal rules does not come at the cost of reducing spending on development objectives. The 2018 *Survey* contains an examination of whether Asia-Pacific economies could make greater use of government borrowing from financial markets in a prudent manner. In general, Governments could afford a higher level of debt if development gaps remain wide, public debt is deemed sustainable and fiscal resources are spent effectively.

51. Available data suggest that many Asia-Pacific economies can afford a higher level of public debt to increase development spending. Public debt levels in 2022 are expected to decrease from the 2017 levels in 11 out of 24 developing Asia-Pacific economies.¹⁹ For this group of economies, the average debt level is considered moderate at 42.5 per cent of GDP in 2017 and is projected to decrease slightly to

¹⁸ The nine developing Asia-Pacific economies covered in the analysis are China, India, Indonesia, Malaysia, the Philippines, the Russian Federation, Thailand, Turkey and Viet Nam.

¹⁹ International Monetary Fund (IMF), *Fiscal Monitor* (October 2017), IMF DataMapper. Available from www.imf.org/external/datamapper/datasets/FM (accessed 12 March 2018).

42 per cent of GDP in 2022. Moreover, according to recent analysis of public debt sustainability, 22 out of 41 developing Asia-Pacific economies exhibit low risk of public debt distress, while eight countries exhibit high risk.²⁰

52. While many Asia-Pacific countries should be able to maintain public debt sustainability under adverse macroeconomic shocks, such as slower economic growth or higher interest rates, public debt sustainability could weaken if contingent liabilities are taken into consideration. For example, countries in the Pacific are highly prone to natural disasters, which has led to large output loss and post-disaster fiscal support. Moreover, banking sector vulnerability in countries such as China and Viet Nam may have risen amid rapid domestic credit growth and the high bank loan-to-deposit ratios in recent years. As bank assets are equivalent to at least 200 per cent of GDP in both countries, the realization of a banking contingent liability could weaken public debt sustainability. In India, a high level of non-performing loans makes its banking sector vulnerable to adverse shocks.

53. In the 2018 Survey, an analysis is presented to explain why some Asia-Pacific economies have been relatively more successful than others in issuing government bonds, in both domestic and international markets. Factors that influence sovereign credit risk ratings, such as past economic growth record, macroeconomic stability, external account vulnerability, fiscal performance, government effectiveness and the quality of the legal and regulatory framework are explored. Overall, the results suggest that the countries that have been able to issue government bonds are those with lower debt stocks, a better regulatory framework and more favourable current account performance.

D. Leveraging of private finance

54. Public financial resources alone are unlikely to be sufficient in supporting policies that are needed to make economies resilient, inclusive and sustainable. There is therefore a need to effectively leverage private capital to enlarge the pool of development finance. One option is that of public-private partnerships for infrastructure projects. Infrastructure is not only the investment area with the largest financing gap, but also the one that exhibits great potential for private investor participation given its expected steady revenue stream.

55. Public-private partnerships represent an alternative approach in providing much-needed public infrastructure. It is a contractual agreement between a public agency and a private entity on a long-term project aimed at providing a public service and infrastructure. Public-private partnerships are particularly useful when fiscal space is small and/or when State capacity to deliver large-scale infrastructure projects is limited. Even when fiscal resources are available and State capacity is adequate, public-private partnerships help shift certain risks relating to infrastructure projects to private investors. Such risks include macroeconomic risks (such as exchange rate fluctuations), operating risks (such as construction cost) and revenue risks (such as number of users).

56. The value of infrastructure investment under public-private partnerships varies significantly across the Asia-Pacific region. In India, the total public-private-partnership investment in infrastructure projects during the period 2010–2016 was about \$183 billion, followed by \$113 billion in Turkey, \$69 billion in the Russian

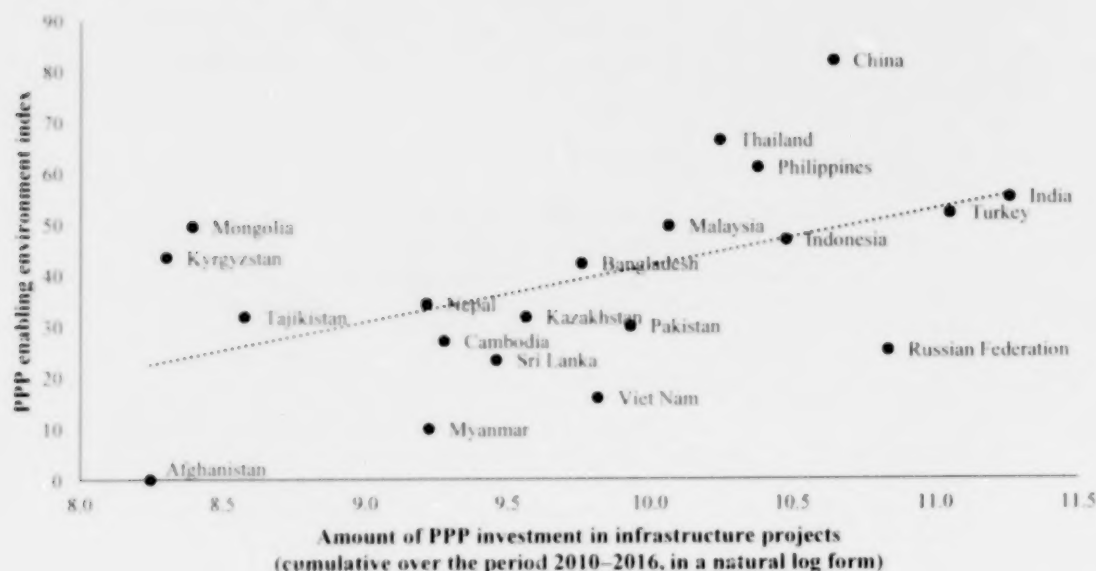
²⁰ The eight countries with high risk of public debt distress are Afghanistan, Kiribati, the Lao People's Democratic Republic, Maldives, the Marshall Islands, Samoa, Sri Lanka and Tuvalu. Source: ESCAP, compiled from 41 reports on IMF Article IV consultations on developing Asia-Pacific economies released since 2016. Available from www.imf.org/external/np/sec/aiv/index.aspx (accessed 12 March 2018).

Federation and \$45 billion in China. When compared to the size of the economy, infrastructure investment under public-private partnerships is relatively large in countries such as Cambodia, the Lao People's Democratic Republic and Maldives.

57. In the 2018 *Survey*, a new composite index that assesses a country's readiness to implement public-private partnerships in infrastructure projects in selected Asia-Pacific economies is proposed. The public-private-partnership enabling environment index comprises five sub-indices: (a) institutional arrangements for public-private partnership projects; (b) past experiences with public-private partnerships; (c) macroeconomic stability; (d) financial market development; and (e) the legal and regulatory framework. In countries with a more enabling environment, public-private-partnership infrastructure projects tend to receive higher risk-adjusted returns and are more commercially viable. Figure III depicts the positive relationship between the value of the new index and the cumulative amount of public-private-partnership investment in infrastructure in developing Asia-Pacific economies over the period 2010–2016.

Figure III

Public-private partnerships in infrastructure projects and the public-private-partnership enabling environment index



Sources: ESCAP analysis, and World Bank, World Development Indicators database, available from <http://databank.worldbank.org/data/reports.aspx?source=World-Development-Indicators> (accessed 12 March 2018).
Abbreviation: PPP, public-private partnership.

58. The analysis shows that a one-unit increase in the value of the public-private-partnership enabling environment index is associated with a 5.1 per cent increase in the amount of infrastructure investment under public-private partnerships. Among the five sub-indices, the impact of the quality of the legal and regulatory framework is the most notable. The results also suggest that financial market development helps boost public-private-partnership investment only if it is accompanied by stable macroeconomic conditions. Within the context of institutional arrangements for public-private-partnership projects, the quality of project preparation and procurement practices are particularly important.

59. Despite significant potential benefits, public-private-partnership projects should be implemented carefully. A possible risk is increased contingent liability, as Governments may need to take over the projects that fail to be delivered by the private partner. Another caveat is potentially high user charges of infrastructure services.

60. To unleash the potential of public-private partnerships and support the issuance of sovereign bonds, financial markets need to be developed further in Asia and the Pacific. Developing financial markets is a long-term task that requires policy action on various fronts, such as: (a) an effective legal framework for the issuance process; (b) a sizeable investor base; (c) a diverse set of financial instruments and services; (d) knowledgeable financial intermediaries; and (e) an enabling market infrastructure, such as credit rating agencies and bond pricing agencies. As an illustration, the 2018 *Survey* contains analyses of two aspects: (a) widening the investor base by increasing the role of institutional investors, such as pension funds and insurance companies, to invest more in infrastructure-linked financial instruments like infrastructure bonds and funds; and (b) diversifying financial instruments by exploring the potential of Islamic finance. A case study of issues surrounding the development of local currency bond markets in the South-East Asian subregion is also presented.

61. The development of local currency bond markets is fundamental and there is room for improvement. Despite recent growth, local currency bond markets in South-East Asia are small and have few actors, low liquidity and relatively short time horizons, which does not favour long-run investments such as those in sustainable infrastructure. Higher volumes of bonds issuance would be positive, as they would complete the yield curve and increase the efficiency of the financial sector to channel savings towards viable sustainable investments. To develop local currency bond markets, countries need to recognize that often the government bond market precedes the corporate bond market. Market actors slowly develop the regulatory framework, infrastructure and know-how to issue and trade government bonds. Once those elements are available, firms can issue their bonds more easily. Legal and regulatory frameworks can also be enhanced by, notably, bringing accounting and taxation practices in line with international practices. Indeed, international cooperation can enhance local currency bond markets by addressing a key obstacle to their development: small economy sizes. Therefore, a promising policy option is to strengthen regional cooperation and integration, as seen in initiatives such as the Multicurrency Bond Issuance Framework of the Association of Southeast Asian Nations plus China, Japan and the Republic of Korea (ASEAN+3).

62. Recent breakthroughs in fintech also hold considerable potential in shaping the prospective role and impact of finance on economies and societies. Fintech has impacts on access to credit and equity (for instance, crowdfunding), financial inclusion (for instance, access to online banking in remote places), and money transfer (through incipient technological breakthroughs, such as blockchain or cashless payments). Such transformations affect the supply of credit and its demand, aggregate demand via easier payments and aggregate supply via innovation and investments. Some subregions of Asia and the Pacific are making considerable investments in fintech. In particular, East and North-East Asia is at the forefront of that transformation, as policymakers are managing its development via regulatory changes and preferential tax schemes, among others.

VI. Concluding remarks

63. The Committee on Macroeconomic Policy, Poverty Reduction and Financing for Development, which held its first session in Bangkok in December 2017, recommended, among others, that the secretariat should enhance synergies in its

analytical work on macroeconomic assessment, policies to reduce poverty and strategies to finance sustainable development in an integrated manner to effectively support the implementation of the 2030 Agenda for Sustainable Development. The 2018 *Survey*, with its sub-theme of mobilizing finance for sustained, inclusive and sustainable economic growth, is an attempt in that direction.

64. According to the 2018 *Survey*, of which the current document is an extended summary, the current strong economic performance in the Asia-Pacific region means that it is an opportune time for Governments to initiate policies that can make economies resilient, inclusive and sustainable. Examples of policy options range from ensuring financial and external sector stability, effectively using and expanding fiscal space, strengthening redistributive measures and social protection, and fostering science, technology and innovation and investments in the relevant skills and infrastructure. The implementation of several of these policies will require not only the channelling of existing financial resources, from both the public and the private sectors, towards the enhancement of the long-term prospects of economies, but also additional financial means.

65. The 2018 *Survey* contains an examination of several elements of such financing strategies that could increase domestic public financial resources and leverage private capital to support sustainable development. The central role of an effective legal and regulatory framework is highlighted. Such a framework is the backbone that helps enhance the three core elements analysed. It brings about efficiency gains in tax administration, favours the role of sovereign bond financing and attracts infrastructure investments under the public-private-partnership modality.

66. The bottom line is that the prospects for mobilizing financing for development purposes are promising. While improving tax administration seems feasible for most countries, the task of increasing the role of sovereign bond financing and attracting more public-private-partnership investment in infrastructure requires well-functioning capital markets and strong technical skills among government agencies. For less developed countries, the role of official development assistance and South-South cooperation remain critical.

67. The Commission is invited to consider the analysis provided in this document, which encourages the pursuit of economic resilience, social inclusiveness and environment sustainability in an integrated manner. The Commission may also wish to review the policy suggestions discussed and provide guidance to the secretariat on these issues.